fundamental approach, but many are devoted exclusively to one technical approach or another. With respect to several publications, it is difficult to determine from their materials what approach is used.

2. METHOD OF STUDY

The study of investment advice consisted of reviewing a substantial body of printed advisory materials distributed during specified periods by a number of broker-dealer and publishing firms, together with additional data from such firms as to their research facilities, personnel and procedures and, through interviews and private hearings, a review of the actual practices and procedures of a number of these and other firms.[231]

The study first obtained a large sampling of advisory material from broker-dealers and subscription publishers,[232] which consisted of all advisory and advertising material and all internal communications of 66 broker-dealer firms and 16 subscription publishers for the 3-month period of April 1 to June 30, 1961. The period was one of a strong bull market which soon thereafter lost its impetus. This material was supplemented by an additional but more limited sampling of similar material for April 16 to June 8, 1962, the period surrounding the May "market break." Factors considered in the initial selection of broker-dealer firms were the extent of their transactions as dealers, their correspondent-firm relations, the number of their branch offices, the distribution of their materials, their representation on corporate boards of directors, the number of their clients who paid a fee for investment advice, and their membership on exchanges. Thirty-six of the firms were members of the New York Stock Exchange. The subscription publishers were selected to obtain firms of varying sizes, including those whose publications were thought to have a subscription following large enough to have an appreciable impact on the investment conduct of the public, firms having a substantial number of clients receiving personal investment advice for a fee, firms with multiple advisory publications, firms using a technical approach to advisory activity, and firms offering advice in such various types of publications as magazines, weekly services, monthly services, and services limited to specific types of securities. From all of these firms, additional information was obtained concerning their research and advisory facilities, personnel and procedures, the distribution of their materials, and related matters.

The material thus obtained formed the basis for selecting particular broker-dealer firms and publishing firms for intensive examination of their advisory practices. In addition, the study reviewed the practices of two larger firms which limit their activities to furnishing personal investment advice for a fee. The study staff also investigated the research procedures involved in a number of security recommendations which had been the subject of numerous recent complaints to the Commission and to Members of Congress, particularly the case of the Dunn Engineering Corp., discussed below. Finally the study reviewed considerable material in the Commission files, including information developed in prior Commission investigations and proceed-

[231] Oral investment advice given by registered representatives is discussed in pt. B, above.

[232] The letters sent to the broker-dealers and investment advisers appear in appendixes III-E through III-H.

ings and the reports of recent field investigations of some 150 registered investment advisers.

3. A CASE STUDY IN INVESTMENT ADVICE: DUNN ENGINEERING CORP.

The impact of investment advice on the securities markets and the importance of the role of the analyst are dramatically illustrated by the history of the Dunn Engineering Corp. (Dunn). The bankruptcy of this company within a few months—even weeks—of its enthusiastic recommendation by broker-dealers and subscription publishers highlights some of more disturbing practices and hardest problems in the investment advisory field. It vividly demonstrates the broad gap which can exist between reality and the rosy recommendations of the advisers and the injury to investors which can result.

Dunn was organized in Massachusetts in 1951 to engage in research, development, and manufacture of electronic components, chiefly in the areas of missile guidance, radar, and specialized checkout equipment. It made its sole public offering in July 1959, when 100,000 shares of its class A stock were sold to the public at $3 per share, pursuant to a regulation A exemption from registration. As a newcomer in the glamorous electronics field, the stock did well. Six months after it was offered it was quoted at 5¼ bid.[233] A year after the offering, it was at 7¾, and by September 30, 1960, the end of the company's fiscal year, it was quoted at 15¾.

In the summer of 1960, the company purchased the Cambridge Engineering Laboratory from Sterling Precision Corp., an acquisition in which Richard Treibick, an employee of Carl M. Loeb, Rhoades & Co. (Loeb Rhoades), was the finder. The cost of this acquisition and management's ambitious plans for research expenditures and overall expansion created a need for additional capital. In March 1961 additional financing was obtained through the sale through Loeb Rhoades of $500,000 of 5-year, 7-percent debentures convertible to stock after March 1, 1962, and the sale to Theodore Gold of 6,667 shares of class A stock for $100,000. Gold, a former employee of Loeb Rhoades, had been an unpaid assistant to the president of Dunn since about the beginning of 1961. Gold immediately resold just under half of the stock to Treibick, who became a director of Dunn and soon thereafter left Loeb Rhoades to form his own broker-dealer firm. Gold became a partner in Treibick's firm but left it in August 1961 to become full-time vice president of Dunn and, in September, its treasurer as well.

In the speculative market of the spring and summer of 1961, Dunn's stock continued to spurt ahead, from 18 in January to 36½ at the time of the financing in March and to an alltime high of 65 in July. The company's operations, however, were far from the success that the price of its stock would suggest. Although Dunn continued to spend large sums on research and development, its sales were insufficient to maintain it on a profitable basis. By October 1961, at least, it was clear to management that the company badly needed more financing. Gold has testified:

> * * * The problem of getting the company new financing and, of course, the problem of acquisitions was real. Both of these problems are intertwined, the problem of acquisitions and problem of financing, raised the problem of getting

[233] All quotes are the highest wholesale bids carried in the National Daily Quotation Service.

additional financing. Now if you look at the September 30 balance sheet you will find that the company was bankrupt as of September 30 and I spent most of my time from the time I became treasurer of Dunn Engineering speaking to people * * * trying to get additional financing * * *.

The September 30 financial statements referred to by Gold, which were not issued to stockholders and the public until November 30, suggested to the careful reader the problems the company was having. While a profit of $112,000 for the year's operations was indicated, it was made possible only by a deferral of research and development expenses of $448,000 and a change in the accounting method from a "completed contract" basis to a "percentage of completion" basis, resulting in a $243,000 increase in stated sales and a $33,000 addition to profits.[234]

On September 28, when the stock had fallen back to 39, a special meeting of shareholders approved a 3-for-1 stock split. This had been proposed to create a better market for Dunn stock so as to aid merger negotiations. At the meeting the president announced highly favorable preliminary results for the year.[235] The annual report to stockholders which included the audited financial statements for the year was released November 30, several days before the annual meeting. The report summed up the year's operations and the company's future in the following manner:

* * * [T]he accomplishments of the past year certainly augur continued prosperity for the company, and we anticipate that the results of the current fiscal year will reflect our optimistic forecast.

The price of Dunn stock, which had by November 28 fallen from 13 (after the three-for-one split) to 9½, rose to 11¼ on December 7 when the annual meeting was held. At the meeting stockholders were told of such encouraging news as a forthcoming acquisition of a west coast company through an exchange of stock (this never materialized) and the market potential of a brushless, direct-drive motor.

Following the annual meeting the company's president, in a letter to stockholders dated December 15, 1961, transmitting an impressive color brochure describing the company and its products, reiterated his statements of the forthcoming west coast acquisition and the market potential of the brushless motor which, he said, "* * * [could] replace every motor operating on direct current where smallness, high-level performance, light weight and low cost are required * * *" and which "* * * should generate excellent sales."

During December, at least one stockholder discussing the stock with Dunn management was told that the stock would soon appear in the investment portfolio of Massachusetts Institute of Technology. MIT did, indeed, acquire shares of Dunn stock, but not through purchase. In December, Loeb Rhodes principals converted $111,000 in face amount of their debentures, some 3½ months before the earliest conversion date provided by the terms of the debentures, and received 18,500 shares of class A common stock which they donated to

[234] The accounting change to a percentage-of-completion basis was reflected in the unaudited financial statement for the 6 months ending Mar. 31, 1961, but the amounts by which sales and reported earnings were affected by this change were not disclosed.

[235] The president's report to the shareholders was summarized in a "Progress Report" dated Sept. 29, 1961, by Schirmer, Atherton & Co., a New York Stock Exchange member firm which had acted as the underwriter of Dunn's original offering and a partner of which had resigned as a Dunn director some 3 weeks earlier. The report made no reference to the change in accounting methods.

the Massachusetts Institute of Technology as a charitable contribution. In January, MIT's ownership of Dunn shares was called to at least one analyst's attention as a bullish factor.

The price of the stock remained relatively firm through January 1962. During this period the officers of Dunn continued to seek the new financing desperately needed for some time, while continuing to express enthusiasm as to the company's prospects in answers to specific inquiries of various analysts and investment advisers.

On February 21, the resignation of Joseph Dunn, the president, was announced and his successor announced to the public that the previous quarter's operations had resulted in a sharp decline in sales and an operating loss of nearly $500,000. Five weeks later a petition in bankruptcy was filed against Dunn by its creditors and by April 9, 1962, when the stockholders were first formally advised of the bankruptcy, the bid price of their stock had plummeted to a range of 3/4 to 1.

While management's published statements during the last 6 months of Dunn's history are unusually lacking in candor, their translation into recommendations to buy Dunn stock was facilitated by superficial and irresponsible securities research practices, of which the Dunn case is by no means an isolated example.

Investment advisers early found Dunn stock an attractive subject, and advisory recommendations concerning it were published in 1960 and 1961 by broker-dealers such as Schirmer, Atherton & Co., Marron Sloss & Co., Browne & Co., and Stearns & Co., and by subscription publications such as Dynamics Letter, OTC Profit Situations, and Dow Theory Forecasts. It was not until the company's last and desperate 6 months, however, that it became a true favorite of the advisers.

The Dunn bandwagon may have had its start from the publication of a cover story entitled "Countdown for Sales Blastoff" in the October 1961 issue of OTC Trader's Graphic, a publication of OTC Publishing Co., with a broad circulation among persons in the industry, as well as among public investors, for which the following advertising claims have been made:

> * * * The articles and other material in Trader's Graphic are of the deep-probing perceptiveness that professionals demand.[236]
>
> * * * * * * *
>
> Trader's Graphic makes no investment recommendations * * *. Instead of advice, Trader's Graphic offers information—through the kind of depth-researched articles, detailed news reports and similar data that analysts and serious fact-seeking investors require.[237]

The OTC Trader's Graphic story on Dunn, with accompanying charts and pictures, was enthusiastic about the company's technical skills and its prospect for future earnings and future business. Its publisher and editor have testified that they were familiar with Dunn because of a previous "buy" recommendation in a June 1960 issue of another publication by the same firm, and it occurred to them that the Trader's Graphic cover article on Dunn would be timely in light of an industry show pending around September 1961. The editor-analyst who prepared the Dunn article has acknowledged

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[236] New York Times, issues of Apr. 9, 15, and 23, 1961, at pp. F11, 32, and F9, respectively.

[237] Id., issues of June 11 and 17, 1961, pp. F7 and 29, respectively.

to the study staff that the only sources of information were the file on the 1960 article, material released by the company, and several telephone conversations between the editor and the company's president.

While the company's yearend financial statements were not available when the October 1961 issue of OTC Trader's Graphic was published, they did become available about the time the same publisher recommended Dunn in its December 1 issue of OTC Profit Situations. This recommendation was prepared by the same editor and based upon the same type of inquiry, including a telephone call to the president of Dunn a few days before publication. When asked whether his research for the recommendation and several "follow-ups" on Dunn included consideration of the annual report, he testified:

> If I saw the annual report, which I think I did, I did not look at it that carefully.

It was not until March 15, 1962, after the resignation of the president and the announcement of the company's current losses, that OTC Profit Situations advised its subscribers to sell.

Another stimulant to the market for Dunn stock was a "confidential" report on the company dated October 6, 1961, prepared by the firm of Treibick, Seiden & Forsyth, which evaluated Dunn as "* * * an attractive speculation" and noted that "[T]he outlook for the next couple of years is excellent." Although the report apparently did not receive general distribution, it was called to the attention of investors by Dunn management and copies were found in the files of an analyst at another firm which became interested and subsequently advised purchase of Dunn stock. At about this same time the Treibick firm started to make a wholesale trading market in Dunn stock. A month later, on November 8, Treibick resigned his Dunn directorship. During most of the next few months before Dunn's bankruptcy, the Treibick firm and its members were the principal source of Dunn stock, selling into the market 90,700 shares, while buying only 48,400 shares, thus substantially liquidating the long position of members of the firm at a considerable profit and supplying much of the stock bought by the public during this period.

A regular reader of OTC Trader's Graphic in the fall of 1961 was Louis D. Hogan, a journalist with no financial experience—his immediately preceding job had been as a writer for "Our Pet World"—who in April 1961, had gone to work as a "writer and researcher" for the publisher of Dynamics Letter, a registered investment adviser. His duties at Dynamics included doing all the research for The Growth Specialist, a publication of Drourr, Lampert & Co., Inc., registered both as a broker-dealer and an investment adviser, whose publication in its entirety was prepared outside the firm during this period. For his recommendation, which appeared in the November 10 issue of The Growth Specialist, Hogan relied on charts, whatever company-published information appeared in his employer's file, and possibly the OTC Trader's Graphic. When questioned by the study staff, he appeared to have little understanding of charts and admitted that both the charts consulted in making the Dunn selection and the data with respect to Dunn in his employer's files were, in his terms, "stale" and "inaccurate." He followed this

first recommendation with a second, in the issue of January 5, 1962, for which his research consisted of—

> Two things: A writeup that I spotted in the Financial Chronicle, in the column that's called "My Favorite Security," and the way the chart looked at the particular time.[238]

The factual content was, he acknowledged, "lifted" from The Commercial and Financial Chronicle article.

Still another reader of OTC Trader's Graphic was Mark Glad, an analyst and salesman who, along with another full-time and one part-time research man, constituted the research department of Filor, Bullard & Smyth (Filor, Bullard), a New York Stock Exchange member firm. Glad had 18 months' experience as an analyst as well as 20 months of other experience and training. In his own words, his job was—

> To come up with situations, investments, trading situations, whatnot, for the customers' men of the firm; to handle inquiries of the customers' men, to review portfolios, and generally work handled by a research department.

He had been following Dunn for some time and became particularly interested in writing a report on the stock after noticing that the price had fallen back from its July high of 66.

Glad's research consisted of using the OTC Trader's Graphic articles as "background," reviewing company reports, and talking with Dunn's management in Cambridge. He submitted a draft of his five-page report to Dunn for approval and corrections. In the report, dated November 1961, he described Dunn's business as involving such esoteric pursuits as "the design, development, and production of radar equipment, missile guidance systems, satellite control and tracking gear, microwave circuitry, and inertial guidance and checkout equipment," and as possessing capabilities extending to "advanced electronic circuit design, microminiaturization, electronics systems synthesis, noise and information theory, optics and infrared detectors." Glad later acknowledged that he had little idea as to the meaning of these terms or the extent of Dunn's activities with respect to them. Nevertheless his report heralded the company "as a sound long-term growth situation" and concluded with the recommendation that—

> Based on the depth of research talent contained in Dunn Engineering and the potential growth of the space electronics industry, the shares, selling at only 18 times minimum earnings projections for this year seem grossly undervalued. Purchase by long-term growth or shorter term speculative accounts seems warranted and is advised.

The report was made available to the investing public through an eye-catching ad in the New York Times of November 25 and 26, 1961, picturing a missile being launched skyward. Filor, Bullard distributed some 1,500 copies and Richard E. Kohn & Co., a New York Stock Exchange member firm correspondent of Filor, Bullard, distributed another 3,000.

Although the company's yearend financial statements were being prepared for public release on November 30, Glad did not wait to see these figures before releasing his research study and advisory recommendation. When he did see Dunn's annual report shortly after his own report had been issued, he was, in his own words, "stunned," since

[238] The writeup is discussed below in this section.

the earnings of which he had been told by management, and upon which his recommendation was largely based, were the result of adoption of the new accounting method and the substantial deferral of research and development expense. This revelation did not, apparenly, dampen his enthusiasm for the stock. In late December he visited the company again and prepared a two-page "Progress Report" in which he stated, "Since my report of Dunn Engineering was written many favorable developments have occurred" and concluded:

> The stock has demonstrated considerable strength in holding at the $13 area and expected favorable developments should result in a higher price in the intermediate future. Continued accumulation is recommended.

On January 12, 1962, this report was initially mailed to some 400 of Filor, Bullard's customers and 100 customers of its correspondent, Richard E. Kohn & Co., and then disseminated more broadly after mention in a New York World Telegram & Sun column entitled "Stock Market Movements and Gossip."

A few days after its release Glad learned that this second favorable recommendation was based on information which was not accurate. He submitted it for comment to Treibick, the partner in Treibick, Seiden & Forsyth who had resigned as a director of Dunn a few months earlier, and whose firm was actively making a market in Dunn stock. Treibick told Glad the report was "silly." Despite these developments, and the doubts he had about the desirability of holding Dunn shares, he did not prepare another report to correct the one issued to reflect his altered opinion. As late as January 31, 1962, Filor, Bullard distributed the "Progress Report" with a salesman's notation: "Still one of the best situations today for capital gains."

However, the announcement of Dunn's substantial first quarter losses and the resignation of its president prompted Glad to prepare a third report, dated February 26, 1962, which summarized the company's condition at the time in the following manner:

> The shares of Dunn Engineering are now more speculative than ever. Their unique success with air bearings along with engineering talent lend some value, but the weak financial condition cannot be overlooked. We reserve any opinion as to the speculative merits of the company until any contracts are received.

This report was never publicly released by Filor, Bullard because it contained an unverified statement to the effect that Dunn's principal creditors had agreed to cooperate with the company. The information was, however, disseminated to the firm's sales force, and its correspondent, Richard E. Kohn & Co., distributed 100 copies of the report.

The chain reaction in Dunn recommendations continued when Victor J. Melone, an analyst who wrote for Growth Investment Services, was stimulated by the Filor, Bullard report on November 1961 to prepare his own report on the company. Growth Investment Services is published by Nuclear Energy Research Bureau, a registered investment adviser. A weekly bulletin of 12 to 16 pages, it contains general market and economic commentary and "buy" recommendations for several stocks, a few of which receive relatively lengthy treatment. Its subscription solicitation material has asserted:

> No one can guarantee any investment against loss, but, in times like these, every investor needs expert analyses and the sound recommendations of properly qualified investment authorities to guide him and help him protect his position. "Growth Investment Services" reports furnish you with exactly this kind of significant and vital service * * * a service that can mean the *difference between*

SECURITY AND CATASTROPHE for you and your family in the uncertain days that lie ahead. [Emphasis in original.]

On December 21, 1961, approximately 1,200 subscribers to Growth Investment Services received an issue bearing the title "A Special Situation in the Aerospace Field—Dunn Engineering." In preparing this recommendation, which spoke most enthusiastically of the company and its prospects, Melone's "* * * major approach was to visit the company and to talk to management." He was much impressed by their enthusiasm about its prospects, and his article, which relied upon management's sales and earnings projections, was almost entirely a repetition of what he was told by Dunn's officers. Although he was aware of the deferral of the research and development expense and the change of accounting method, he could not recall having questioned company officials about them, and his report failed to mention them in contrasting the 1961 reported earnings of $112,487 with a deficit of $126,000 in the prior year. It spoke only of Dunn's additional expenditure of "about $750,000 or the equivalent of $1.44 on the outstanding shares" for research and development in a manner which, he later conceded, might convey the impression that actual earnings were understated by the $1.44.

Growth Investment Services continued to follow Dunn for its subscribers. In its January 11, 1962 edition, Dunn was again recommended as a stock which "can be looked upon for gains in the coming months." After the resignations of Joseph Dunn and Gold were announced, and the disastrous results for the first quarter of fiscal 1962 were released on February 21, a third Growth Investment report dated the following day told subscribers: "The longer term situation is good and we would advise clients to hold at these levels." The report ascribed the drop in the stock's price at that time to competition encountered in the company's bidding for contracts, information which Melone obtained a few days earlier by telephone from Joseph Dunn, who, according to Melone, made no mention of the very bad situation that the company was in. Again, on March 1, subscribers were told that the "situation is highly speculative, but the company retains strength from its technical competence," and "* * * averaging at $3 to $4 level seems warranted now based on the expectation of contract receipts and the early resolution of present difficulties." On April 12, 2 weeks after Dunn was forced into bankruptcy, Growth Investment Services subscribers were advised to sell their Dunn stock.

In late 1961 and early 1962, Dunn also proved popular with a number of other subscription publishers. In late December, following the first Growth Investment Services recommendation, the Science & Electronics Newsletter, published by Spear & Staff, Inc., a registered investment adviser, featured Dunn as "A Low-Priced Speculative Buy" in a page-and-a-half story in its December 22 issue, which went to approximately 5,000 subscribers. This recommendation was stimulated by a telephone call from Robert Eckhouse, head of the financial public relations firm retained by Dunn, who suggested that the stock be considered for recommendation and supplied the background information. The article and recommendation were based upon the Eckhouse material, a telephone call to an engineer to check on the soundness of Dunn's product line, and information to the effect that Dunn

had recently been successful in obtaining a bank loan. The Spear & Staff writeup concluded:

STOCK REPRESENTS A GOOD OPPORTUNITY TO PARTICIPATE IN A STRONG GROWTH SITUATION AT A FAIRLY REASONABLE PRICE. WE BELIEVE THAT THE SHARES WILL MOVE HIGHER IN 1962, REFLECTING THE SUBSTANTIAL GAINS ENVISIONED FOR SALES AND EARNINGS. * * * [Emphasis in original.]

There followed a second recommendation on January 19. A third, a one-page writeup on March 2, acknowledged the company's difficulties, but stated, "In our opinion, Dunn's well-established product line, technical know-how and good record are basic strong points, which will pull the company out of its present troubles," and concluded:

* * * If you can afford high risk, new purchases made here might prove very rewarding. Otherwise we advise holding for the time being until a more definitive conclusion can be formed about the company's outlook for 1962.

On March 30, 1962, Spear & Staff advised its subscribers to sell.

Copies of the Spear & Staff Science & Electronics Newsletter recommendations were sent by Eckhouse to other analysts in early 1962, in an endeavor to stimulate further investor interest in the stock. He also supplied material about Dunn, including the Filor, Bullard report of November 1961, to Financial World, a weekly financial magazine, which used it in a published study of a group of electronics stocks.

In the same period Traders Research Letter, published by a registered investment adviser, featured Dunn in its January 15 issue, which went to its approximately 25 subscribers and 300 names taken from a mailing list. Its two-page writeup, drawn from previous published market letters, noted that "*Dunn Engineering Corp. has concluded the most successful year* in its history" [emphasis in original], and concluded with a recommendation in the following language:

A true science stock * * * Price-earnings ratios and normal formula considerations must go out the window.* * * It would be impossible to rationalize a coherent basis for accumulation of these shares, and yet we go along with the general expression of confidence Wall Street has illustrated in these shares. Accumulation is warranted by the young and strong at heart.

Traders Research Letter also added 200 shares of Dunn to its model portfolio of "a hypothetical $10,000 for a hypothetical young executive" with "the highest possible capital appreciation" as his goal.

Another noteworthy expression of broker-dealer interest in Dunn came from Sirota, Taylor & Co., an over-the-counter retail house. In late November 1961, Howard Stillman, a registered representative and analyst with several years' experience and the firm's one-man research department, who had previously noted the Dunn recommendation in the first Filor, Bullard report, learned that his firm had a substantial position in Dunn stock. It was, he has testified, his practice to try to recommend securities in which his firm had a position or interest.[239] After reviewing various reports and information which Dunn had provided its stockholders, the Filor, Bullard report, and the Melone article in Growth Investment Services of December 21, 1961, and after

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[239] As he stated it: "* * * when one is employed by an individual, he tries to lean toward the stocks that the principals favor if they appear attractive enough to him in all honesty. This is the practice in the trade. You try to recommend securities that the firm has an interest in."

a lengthy telephone call with the president of the company, Stillman prepared an article on Dunn which concluded:

> Possessing the ability to test the complete reliability of missile and space craft systems, Dunn is in the unique position of being exposed to all areas of the aerospace field. Combining this factor with its wealth of managerial talent for its size and the favorable possibilities of its commercial ventures, Dunn Engineering provides the investor attractive speculative potential for capital gains.

Stillman forwarded the report to the Commercial and Financial Chronicle where, in the January 4, 1962 issue, it received nationwide distribution under the title "The Security I Like Best * * *" and under Stillman's byline as guest analyst. It contained no reference to the firm's position in the stock. To insure greater distribution, Stillman stood at the door of the next meeting of the New York Society of Junior Analysts, of which he was a member, and handed out reprints. Additional distribution came from the use of reprints by Filor, Bullard salesmen in soliciting customers for Dunn stock. The Sirota, Taylor firm also mailed several hundred reprints to potential retail customers, some of whom bought stock as customers of Stillman. Stillman also prepared a favorable "progress report" on Dunn which was distributed on January 18.

Finally, a subscription publication which had recommended Dunn several times in 1961, Dynamics Letter, again recommended the stock as a "buy" in its January 9 and February 9, 1962 issues. On February 23, Dunn was mentioned as a stock to be "avoided or sold," and "sell" was recommended on April 6. When questioned about the Dunn recommendations and his knowledge of the company, the editor and publisher of Dynamics testified:

> Question. You did not know until I told you that it (Dunn) went to 65?
> Answer. That's right.
> Question. And you did not know it had gone into bankruptcy?
> Answer. That's right.
> Question. * * * (Y)ou missed the ball game completely.
> Answer. That's what it looks like.

Ultimately, of course, it is the investor who is injured by faulty research practices, and a large number were hurt in the Dunn case. Treibick described the renewed investor interest in Dunn following the Filor, Bullard report in this way: "All of a sudden instead of 5 people in the pink sheets, there were 15 and there was a tremendous accumulation going on in the stock." In fact, even greater interest was shown in the stock. During the period, from September 1, 1961, through March 31, 1962, at least 22 different broker-dealers made markets in the stock, and it was bought by customers of at least 65 different firms, including some of the larger retail wire houses whose salesmen, in some cases, solicited their retail customers to buy the stock. For example, a registered representative in the Milwaukee office of Walston & Co., who relied upon the recommendations of other advisers including Filor, Bullard, Sirota, Taylor, and Growth Investors Service recommended the stock to his accounts at the end of January and they purchased about 4,400 shares.

More than 20 investors have complained to the Commission alone, and some of their letters raise significant questions. A Michigan lawyer who made an investment of over $2,750 on the recommendations of Drourr, Lampert's Growth Specialist and the story in OTC Trader's Graphic, and who made his purchase through Drourr, Lampert, asked whether investors have any remedy when they suffer loss

after relying on such advice. Another investor who "relied entirely on the word" of Filor, Bullard, asked in his letter:

Is it up to the investor to personally investigate each and every stock he buys or does the broker have some responsibility when he recommends a stock for purchase?

Another investor complained to the New York Stock Exchange that the reports issued by Filor, Bullard and nonmember Sirota, Taylor, raise a—

* * * question in the minds of the investor as to how recent reports of such nature could be issued by reputable companies in the face of events of opposite nature which were happening at the same time. * * * A situation such as [this] * * * does much to destroy the confidence of the investor and nullify to a large extent the advertising so often issued by the members of the stock exchange.

The reply of the New York Stock Exchange, following its standard procedure in processing complaints of this sort,[240] sets forth its views as to the responsibility of member firms for their advice:

We would like to point out that it is expected that recommendations for the purchase or sale of securities made by officers, partners or employees of member firms should be given in entirely good faith and based upon what is believed to be reliable sources of information.

In the case at hand, it appears that officials of the Dunn Engineering Co., were contacted with regard to the information contained in the report and also were contacted prior to the release of this report. Therefore, the firm would be under the impression that their information was derived from reliable sources. Also, it would appear that they acted in good faith in issuing the reports to their customers.

An investor "in [his] seventies, trying to accumulate enough money to retire" made his $2,200 investment "on the assumption that the statements of a member of the New York Stock Exchange could be relied on as reasonably factual, intelligent, and informed," and commented that the matter "brings into question the integrity of supposedly reliable sources of information regarding security values." A major in the U.S. Air Force who, with fellow officers, relied upon the recommendations of Sirota, Taylor, noted:

It would be interesting to know what stock position in Dunn Engineering was maintained by Sirota, Taylor & Co., Inc., during this period. If there is no fraud involved, I would conclude that [the analyst] performed his analysis in a mental vacuum.[241]

Much of the criticism, of course, is addressed to the company itself. One investor, who is also an investment adviser, wrote:

Both as an investor and an investment counselor, we are appalled by some of the erroneous information supplied by officials of publicly held corporations. This is especially true with (*a*) the release of interim reports that portray a most favorable picture which pushes up the price of the stock, only to have, "yearend adjustments that no one expected," make the interim statement a complete farce; (*b*) overly optimistic announcements by company officers in speeches or press releases that fail to take into account "those numerous unexpected disappointing obstacles" that cause a sharp downward revision of projections.[242]

* * * Every stockholder of a public corporation likes to see his stock appreciate in value. When the movement is based on misleading information, as in the case of Dunn Engineering, the gains are short lived, except for the insider who knows what the true picture is and probably takes advantage of it.

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[240] For a discussion of exchange procedures, see ch. XII.

[241] It was the firm's position that prompted the analyst to prepare the report, as noted above.

[242] These problems are considered in detail in ch. IX.C on "Corporate Publicity."

The comments of the disappointed Dunn investors reveal what they expect of the written investment advice they receive, whether it comes from a broker-dealer or a subscription publisher. They expect it to be factual, informed, intelligent, and unbiased. Much of the advice disseminated on Dunn was none of these things. An analysis of the study's findings suggests a number of reasons why it was not.

What happened in the case of Dunn is a reflection of the market temper of the time, the hysteria of the 1961 bull market which has been commented on so often both within and outside of this report. At such times certain types of stocks achieve a striking popularity or "glamour," the phrase "speculative issue" becomes an invitation rather than a warning, and "growth" becomes the magic word to be substituted for rational analysis. The enthusiasm of one adviser infects others. A principal of one broker-dealer firm summed it up in this manner:

> * * * It is almost like follow-the-leader * * *. As you know, people go in masses, even in sophisticated Wall Street. Some firm is alerted to a situation by the discussion of some other firm who writes it up. They get a copy, and they get their research department to look into it. All of a sudden, now, five to six different firms have written the stock up.

During these periods, those charged with research responsibilities are often subject to great pressure, in the words of Glad, "to come up with situations, investments, trading situations, what not, for the customers' men of the firm." It is hardly surprising that such constant pressures can dull the sharp blade of analytic judgment. It will be even more blunted for analysts who, like the one at Sirota, Taylor, regard it as their function to supply favorable recommendations on stocks in which their employer has an interest.

But most important, the Dunn case illustrates the complexities and the significance of the research process underlying sound investment advice. Much is expected of the security analyst today. With management the principal potential source of the information he wants, he must understand the natural tendency on the part of even responsible management to supply only favorable information and to withhold unfavorable data, and he must be alert to detect the danger signals. He must have a basic understanding of the various aspects of the company's activities, its problems and prospects, and those of the industry or industries in which it competes, and must have a thorough knowledge of accounting procedures and their significance. And he must, of course, resist the pressures that would subvert his independent judgment.

The study's survey revealed research practices ranging from those on the level found in the Dunn case and worse, to meticulous investigations. Dunn does, however, illustrate many problems which appear with disturbing frequency in the entire field. The following sections of the report examine more broadly the material produced and the methods followed by the three groups providing investment advice, the broker-dealers, the advisory services, and the personal advisers for a fee.

4. BROKER-DEALER INVESTMENT ADVICE

a. The nature of published advice

Almost all investment advice put forth by broker-dealers has, as already noted, the primary aim of selling securities. This is true, of course, of the oral advice given by security salesmen to their customers,

and equally true of the printed advice circulated by broker-dealers. From a review of the substantial body of printed material gathered by the study from broker-dealers covering the 3-month period in 1961 and 2 months in 1962, certain general observations can be made.

Most of the published material distributed by broker-dealers is in one of two general categories: brief "market letters" and longer "research reports." The market letters or bulletins usually consist of one or two pages, though they may be longer. Some are published regularly on a daily, weekly, biweekly or monthly basis, and others published irregularly. Some concentrate on one or two companies, but more contain very brief writeups of a larger number of securities, ranging up to 20 or more in a single issue. Often they also contain quotations and recommendations from various financial publications and services. Most letters are sent to a large mailing list including most of the distributing firm's existing customers and often a large number of potential ones. Still another type of market letter, which generally receives a more limited distribution and is presumably of greater interest to persons in the industry and traders than to investors, is the brief and general market commentary, often of a technical nature and often containing numerous very brief recommendations.

Research reports are more detailed analyses of particular companies or entire industries, and are usually several pages in length. Most of these reports are distributed to the smallest mailing list, sometimes only to a select group of institutional investors, or in some cases to such groups before general distribution. They may also be mentioned in advertisements as available for interested investors, and the persons requesting copies thus become potential firm customers.

A number of the firms from whom the study requested material, including both New York Stock Exchange member firms and nonmember firms, made no public distribution of any material during the 3 months of 1961 covered by the survey. For the most part, these are firms without any substantial number of public retail customers, including such over-the-counter wholesale houses as Singer, Bean & Mackie, Inc., and Troster, Singer & Co. Stock exchange member firms distributing market letters exhibited a strong predilection for listed securities. Some described and suggested only listed stocks during the period, though the majority also recommended some over-the-counter stocks and McDonnell & Co., a firm which emphasized the growth factor in its advertising, favored unlisted companies throughout its materials. Nonmember firms, as might be expected, lean heavily to unlisted securities for their recommendations. As a class, nonmember firms distributed fewer releases than member firms and with far less regularity; several issued only occasional research reports, covering not more than a single company. Few member and nonmember firms recommended preferred stocks or bonds in their material although there were occasional recommendations of securities with convertible features.

Despite differences in emphasis, style, quality, and quantity, one common factor stands out. The advice offered in published materials of a fundamental rather than purely technical nature is predominately "buy" advice. Its tone may be restrained and dignified, or it may be exuberant and flamboyant; its recommendations may be expressed as such or merely implied; but it is basically designed to stimulate

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purchases. Recommendations to sell are, as is shown below, for the most part, deliberately avoided.

At the core of almost all recommendations is the projection. Projections range in form from the blatant prediction of a market price to be expected in the future [243] to the more subdued insertion of an asterisk after an earnings figure, keyed to the explanation that the earnings in question were "estimated." Projections of estimated earnings are conspicuous throughout. Ordinarily this projection explains briefly why earnings could be expected to increase, and often goes on to state the anticipated increase—for example, "1961 earnings are expected to continue the uptrend and are expected to better the $2.71 earnings a share of 1960," or "net for the year should be better than the 1960 figure by a good margin and climb to something in the neighborhood of $2.60 a share." Generally, earnings projections are not left to stand alone. The reader is reminded of their corollary, a higher market price.

Besides the projection, the paragraph of recommendation usually gives some brief description of the business of the company and its prospects—often glowing—in its industry. In many cases the security is also classified in terms of a general investment goal, i.e., "for the investor seeking long-term capital gain through a conservative growth medium," "particularly attractive for both near- and long-term appreciation," "suitable commitment for income-seeking account," or "for those who wish to make a speculative commitment." Similarly several firms which periodically publish security lists described as "supervised portfolios" classified the listed issues generally in terms of risk, e.g., "For Income," "For Growth and Income," or "Business Man's Risk."

In the speculative spring of 1961, when price-earnings ratios were high and yields were low, the would-be investor was often left to make these arithmetical computations by himself. On the other hand in 1962, with stock prices depressed, more general attention was directed to price-earnings ratios.

Beyond a general classification as to investment goals, little if any effort is made in most advisory materials to evaluate risks for the investor. There are references to "little downside risk" or "assured dividends," although such words as "safe" are seldom found. On the other hand, even when speculative and highly risky securities are recommended, rarely is there any reference to adverse data which the Commission has held must be disclosed to investors in solicited sales of such stocks.[244]

The limited number of suggestions found in the advisory materials to "sell" or "switch" were usually in those daily or weekly market letters, generally intended for the trader, which make recommendations with little, if any, supporting data. One member firm, Cohen, Simonson & Co., a New York Stock Exchange member firm, on May 10, 1961, recommended 32 separate stocks for purchase by simply naming companies, giving a "buying point" (which in 13 cases was "at the market") but no supporting data, and a week later recommended 38 stocks under the title "Low-priced speculative stocks

[243] One of the largest member firms in a special research release published a list of "favorites" for long-term appreciation with a "target price."

[244] *Mac Robbins & Co., Inc.*, Securities Exchange Act release No. 6846 (July 11, 1962). *Leonard Burton Corporation*, Securities Exchange Act release No. 5978 (June 4, 1959).

recommended for purchase," again without supporting data. Another member firm, Winslow, Cohu & Stetson, Inc., on April 10, 1961, produced what may represent a classic of this type of recommendation, offering the investor the allure and style of the racing form:

We hear that—

* * * * * * *

Monsanto Chemical (45)

Could earn $3 on business pickup. Stock looks cheap here.

Simmons (55)

Fourteen-year average earnings $5.30. Brunswick Corp. has offered to merge. Simmons big supplier of hospital beds. One of the more moderately priced issues on past earnings.

Reeves Bros. (21)

Has three interesting new product lines that could produce much bigger earnings: (1) microporous materials, (2) Curon foam, (3) polypropylene fibers.

Ward Industries (120)

Poor record. But new deep-freezing method with liquid hydrogen—no need for refrigerated cars—could prove winner.

Anaconda (54)

Babcock & Wilcox (42)

Look like good values here.

Motorola (87)

First quarter net to be one-third off.

Columbia Broadcasting (38)

Earnings in 1961 likely to exceed 1959 record $3.01 a share.

"Defensive" stocks

So high no longer defensive; cyclical stocks offer better values now.

Sinclair (44)

Could earn $4 this year. A 25-percent capital gain envisioned before end of 1961.

Celanese (37)

Should earn $2.25–$2.30, plus 75 cents a share in unconsolidated earnings equity. Price of 50 possible this year.

Central Louisiana Gas & Electric (O–C 32)

Earnings $1.30, pays $1. In fast-growing area. Three-percent yield, partly tax free. New capacity should lift earnings in another year or two. Interesting growth utility.

Seeman Bros. (37)

ACF Wrigley (21)

Both stocks have moved up about as far as entitled.

Kendall Co. (39)

Strong unit in hospital supply field. Should better $2.44 earnings of 1960 this year.

Draper Corp. (34)

Could earn $3 this year. Debt-free textile machinery company.

McNeill Engineering (41)

Has remarkable record of internal growth. Low P/E ratio partly traceable to nonstock-minded management. Stock closely held.

Kress (22)

Stock going nowhere in bull market. Turned down 28 offer as too low. Five properties sold and tax-loss carry-forward resulted. Richard Buck & Co. persistent buyers.

Giddings & Lewis (*O–C 21–22*)

Fifty percent below earlier levels, a good spec.

Natomas (*11*)

Price of 20 visualized. Liked by some leading brokerage firms, including Hayden, Stone, and W. E. Hutton.

* * * * * * *

The report ends with a standard hedge clause which states that additional information with respect to the companies mentioned herein is available upon request.

The extent of a firm's obligation to follow a security recommended and to advise recipients of its published advice of significant changes in the circumstances of the company is a matter of some difference of opinion in the industry. The head of research at one member firm suggested to the study that there may be a "moral obligation" to follow any recommended security and give periodic reports until a "sell" recommendation is made. Such followup information is a part of the service regularly performed by some firms for their large institutional clients. Some firms publishing a "supervised portfolio" or recommended list will follow the approved securities and remove them from the list when changed circumstances warrant such removal, without, however, drawing particular attention to the change. However, most firms interviewed indicated that no organized effort is made to follow up on stocks favorably recommended. Some firms do report unfavorable news to their sales staffs by interoffice wire "flashes" or sales meetings, leaving their salesmen to communicate such advice orally to their customers, but it may be doubted whether advice so communicated reaches a substantial portion of the persons who may have relied on the original recommendation.

Broker-dealer firms make no secret of their reluctance to publish "sell" advice. "We would never print a report on a company telling people to run out and sell their stock," a representative of one firm told the study. The partner in charge of research for another firm explained that sell recommendations to the public are generally "bad business." Most firms interviewed expressed the concern that publication of "sell" advice might result in losing management as a source of information. Equally important for firms for which underwriting is an important source of income is the fear of losing potential future underwriting business as a result of management's adverse reaction. Lastly, some firms express the view that to publish such information would create problems with respect to customers who might receive the advice late.

Not all analysts are happy with this restraint on the exercise of their function. The analyst in charge of research at one broker-dealer firm commented to the study on the adverse reaction after he had recommended the sale of a stock which previously his firm had favored. The president of the issuer, he said, "was quite upset about the sell recommendation in our December letter. Now, this in itself indicated some sort of, let's say, weakness on his part, to my mind, at least, in the sense that it showed some preoccupation with [the] common stock. * * * At least I should have the freedom of choice as to what we recommend and don't recommend."

Since market letter recommendations are almost invariably brief, merely reading them would rarely enable anyone to determine the

nature of the information on which the analyst relied. They are occasionally signed by the name or initials of the person responsible for their preparation but they can be and are the result of anything from the ultimate distillation of a long and painstaking analysis of the recommended company, its industry and the economy as a whole, to mere "cribbing" from a statistical service or another market letter. Services are cited only when actually quoted, and the source of published figures is rarely given. And, in some instances, the recommendations are undated.

It is equally difficult, from the face of most of the advisory materials, to determine whether the securities recommended are owned by the firm or if they are stocks in which the firm is making a market. In all of the material reviewed, less than a dozen pieces note in the text the fact of ownership by the recommending firm, and in two of these cases the literature is directed to other dealers. In those few cases where the text does indicate ownership, there is no indication of the size of the position,[245] or of any intended disposition.

As it is quite possible that a recipient of written material may rely to his detriment on the advice contained in it, broker-dealers almost universally make use of a "hedge clause," sometimes called a "disclaimer clause," which presumably is assumed to limit liability for their factual and advisory content. These clauses generally appear in fine print at the bottom of the page of the recommendation.

Hedge clauses generally contain three elements. Factual data is usually said to be obtained "from sources believed reliable," and often additional information on companies recommended is said to be available upon request, but responsibility for completeness or accuracy is disclaimed, and one looks in vain here, as in the recommendations themselves, for any indication of the nature of the "reliable sources." Indeed, as has been recently pointed out by the Commission, such a hedge clause statement may mislead rather than inform:

> * * * the overall aspect of the market letter deserves mention. In final form, it was designed to leave an impression with the reader that here was a recommendation produced by the "research" department of a broker-dealer firm reflecting the objective weighing of significant developments in a new business. * * * The impression thus created was false. The formal legend at the end of the letter itself contributed to the deception. The first sentence of this legend states in part: This information contained herein has been obtained from statistical sources, trade or other sources which we consider reliable. * * * This is followed by the assurance that, "Any opinions expressed herein reflect our judgment at this date. * * *" This legend, cautioning the reader as to possible limitations on the completeness and accuracy of the contents of the letter assembled by the "research department," suggests the employment by the firm of objective, careful procedures totally at variance with the deliberate fabrication engaged in by the registrant * * *.[246]

Secondly, reference is made to the possibility that the firm or its personnel may own shares of the stock recommended, but, as already noted, disclosure of actual holdings is rare and no statement of intentions as to such holdings is made. A typically obscure statement of this sort was contained in the market letter of Stearns & Co., a New York Stock Exchange member firm, which stated:

> In the general course of business, partners of and/or the firm of, and/or the employees of Stearns & Co., may or may not have a position, long or short, in

[245] Some broker-dealer firms whose material was not reviewed do, however, reveal both the existence of a position and give some indication of its size.
[246] *Heft, Kahn & Infante, Inc.*, Securities Exchange Act release No. 7020 (Feb. 11, 1963).

the securities mentioned, and from time to time may be executing buy and/or sell orders for themselves and/or their customers.

The relevant facts which such language may mask are illustrated in the case of a "progress report" of Equitable Securities Corp. of Nashville, dated May 31, 1962, which strongly recommended purchase of Fox-Stanley Photo Products, Inc. In language similar to the above, the hedge clause stated: "From time to time we may buy and sell the securities referred to herein and may have a long or short position therein." From trading data obtained by the study it appears that throughout at least the 5 months prior to the publication of the report, the firm had a substantial position in the stock and, on June 1, immediately after the date of release, its long position amounted to 76,174 shares.

Finally, the hedge clause generally includes the statement that the material "does not constitute a solicitation for the purchase or sale of any securities," despite the express or strongly implied recommendations it generally contains and despite its circulation to firm customers and potential customers. In this connection it is interesting to note the contrast between the language of some recommendations and their accompanying hedges, of which the following is an example:

RECOMMENDATION

* * * the common shares of Jefferson Electric Co., represented an investment value, and we recommend purchase for growth portfolios.

HEDGE

* * * Neither the information presented nor any opinion expressed constitutes a representation by us or a solicitation of the purchase or sale of any securities. * * *

To say that the ultimate purpose of all of this published material is to stimulate the sale of securities should not imply that the corollary function of service is undertaken without sincerity. Nevertheless, from the study's examination, it is clear that much of the material is of limited value to the investor in the selection and supervision of a suitable portfolio, or in guiding him as to wise general investment policy.

b. The nature of research practices

The foundation of all investment advice is, of course, the research which underlies it. The study examined the research practices and patterns of a number of broker-dealer firms. The examination reveals striking variations in the practices followed, not only among different firms but also within particular firms. These differences are due of course to differences between firms, but also to the different functions which the research is intended to serve. The study also found that frequently there is a broad gap between the practices followed and the standards professed to the public.

The research personnel of a broker-dealer firm are called upon to perform a number of functions. They ordinarily prepare whatever published material the firm distributes to the public, including the market letters, bulletins, and reports discussed in the prior section. In large firms, particularly those with many branch offices, personnel are often called on to prepare internal publications and recommended lists for distribution to the selling staff. For the selling staff the

researchers are also required to answer innumerable individual inquiries concerning particular securities which have attracted the interest of a salesman or his customer. In the many firms that provide portfolio review or personalized advice on a fee basis, these too are part of the duties of the research department. Finally, many firms undertake special advisory services for institutional customers in addition to the research involved in the preparation of detailed research reports for dissemination to such customers.

(1) *Adequacy of research staffs*

Primarily, effective research is a reflection of the individual and depends, among other things, upon his training, ability, and integrity. Accordingly, the mere size of a broker-dealer's research department is no necessary indication of the quality of the research and advisory materials it can provide. On the other hand there are obvious physical limitations on the amount of material which even a full-time analyst can competently prepare for publication or internal distribution, the number of securities which he can intelligently investigate and follow, the number of registered representatives he can adequately service, and the number of portfolios he can responsibly review. The limitations in every firm naturally depend on the nature of the business it transacts. The research partner of one large retail broker-dealer estimated the ideal ratio of salesmen to analysts for his firm as 25 to 1. Other firms employ a ratio as low as 10 to 1. In firms without full-time research personnel, the analyst's other duties obviously limit the advisory activities he can reasonably undertake. Whatever ideal or minimal standards may be assumed, it is clear from the study's investigation that some firms operate with a staff insufficient to perform reliably the tasks which their firms hold themselves out to the public as equipped to handle.

Bruns, Nordeman & Co., a New York Stock Exchange member firm, for example, published a weekly market letter sometimes circulated to as many as 7,000 persons. At the time this firm was interviewed by study representatives, this publication was produced by a research department consisting of one analyst, who, in addition, serviced the questions from the firm's 74 registered representatives, did portfolio reviews at the request of customers or firm salesmen, and supplemented his salary through commissions on sales to his own customers. Although the April 6, 1961 issue of the market letter stated, "* * * all recommendations have been carefully surveyed in terms of quality and risks as well as potential rewards" and the firm has stated that its quarterly list of securities consists of stocks which are "carefully selected on individual merit and * * * periodically subject to renewed inspection," the analyst's research was limited to a review of company reports, of recommendations of other brokerage firms and of a select number of advisory services, and of information in the statistical manuals. In recognition of the limitations on his time, when selecting securities for recommendation in the market letter and the quarterly list, the analyst generally avoided consideration of stocks which were not listed on the New York Stock Exchange. Both he and his employer concede that such research is intended to do no more than put selling literature in the hands of the firm's customers and registered representatives, which it views as a competitive necessity.

The descriptions of their respective research procedures supplied by the broker-dealer firms distributing printed or advisory materials to their salesmen and customers indicate that the situation at Bruns, Nordeman, while not prevailing, is by no means uncommon. It is not unusual for firms to maintain research departments so small and so limited in time devoted to research activities as to render unlikely a thorough, independent study of the securities which they recommend. Edwards & Hanly, another New York Stock Exchange firm which does an extensive retail business directed primarily to the "blue collar" investor and had 9 branch offices and approximately 150 salesmen and trainees, in 1962 maintained a research department consisting of 1 experienced analyst and 4 junior analysts. This staff worked under the supervision of the managing partner, who had had some prior experience as a securities analyst and, in addition to handling the normal flow of salesmen's inquiries and some portfolio analysis, prepared the following for distribution by the firm: two weekly market letters containing numerous recommendations, a bimonthly market letter, two selected lists, one of 42 "high yielding" stocks and one of 48 "growth stocks" which "should continue to outperform the general market over the long term," and, at irregular intervals, numerous industry and company analyses. This research department was organized after the abandonment in 1961 of an "unsatisfactory" situation which had previously existed, in that several branch managers had prepared and distributed their own advisory materials without prior review by the firm. At this firm too, which advertised its "expert advice," the efforts of the research department were, in the main, limited to a review of standard statistical manuals and financial services, and information released by the companies, and the firm's partners placed a low value on research, except as a means of providing the advisory materials which are "expected."

A somewhat similar situation on a larger scale existed in Dempsey-Tegeler & Co., a large New York Stock Exchange firm with nearly 500 salesmen, including trainees, operating out of 44 offices concentrated in the Midwest, Southwest, and Pacific coast areas. Numerous advertisements soliciting customers contained such statements as "stockwatchers by the hundreds look to Dempsey-Tegeler for expert advice" and "Dempsey-Tegeler maintains a special research department to keep its clients advised of all market developments." Its research department in early 1961 consisted of seven men in Los Angeles and one in St. Louis. Of the seven in Los Angeles, three were officers of the company, each of whom handled numerous accounts; two were on the investment "advisory committee" and the third supervised research activities. The other four in the Los Angeles department included two analysts, one "research associate," and one portfolio reviewer. One of the analysts spent more than 80 percent of his time on his own customers, from whom he derived $53,000 in commissions in 1961, compared to $2,500 in analyst's salary. Another was a journalist, principally concerned with editing and maintaining an orderly flow of material from that office. The portfolio reviewer devoted himself to that task. The St. Louis analyst devoted over 50 percent of his time to portfolio review, while also deriving part of his income from handling the accounts of his own customers.

As might be expected, a major effort of a research department serving so many salesmen is answering inquiries. One of the analysts

commented that before he arbitrarily limited the number of calls he would take, he received as many as 60 calls a day, and could get little done in the way of research. In addition to handling these inquiries and, as indicated, carrying on considerable portfolio review, the research department produced a monthly editorialized market letter, and a weekly letter called Current Comment, with a 50,000 circulation, as well as numerous special reports, individual company reports, institutional reports, and internal advisory memoranda.

At this firm, branch offices, including those in San Antonio, Minneapolis, and Kansas City, distributed research reports and market letters without supervision by the firm's research personnel and salesmen were free to initiate recommendations on the basis of the advisory recommendations of others. Both procedures were discontinued early in 1962.

In contrast, the New York Stock Exchange member firm of Smith, Barney & Co., with 118 active salesmen and 13 offices throughout the country, had a research department consisting of 13 senior analysts, each assisted by a junior analyst and, with one exception, each responsible for two industries. The firm issues only two forms of printed advisory material, "Research Studies" of individual companies and industries, and a weekly "Commentary," commenting upon and recommending stocks in which there is not sufficient breadth of interest to justify a research study, or where there was no time for such a study. The Commentary is based upon the weekly meeting of the firm's analytical department. Each senior analyst prepares, on the average, about one research study each 2 weeks, the preparation of which always involves a field trip and visit with management. According to the firm, this material is mailed simultaneously to the firm's salesmen and to its list of institutional customers who have agreed to give the firm a certain amount of brokerage business annually, and it receives no other distribution. The analyst's evaluation is published, irrespective of whether it is favorable or unfavorable. As the partner in charge of the firm's research department put it, "They come to respect us for it." Portfolio review in this firm is a full-time occupation of the one senior analyst who is not responsible for research studies.

Economics and limitations of time and personnel frequently impel broker-dealer firms to rely on outside sources to supply some or all of their research material and advisory information. This is done in several ways. Sometimes, as has been indicated, it involves the heavy reliance of a research department on the statistical services and advisory materials of other firms. Occasionally it involves the circulation by one broker-dealer of material prepared by other broker-dealers and by public relations firms. Some firms turn to outside research organizations.

The two statistical services most frequently used in research, and relied on by all analysts to one degree or another, are Standard & Poor's Corporation Records and Moody's Industrial Manual. Both offer statistical information on securities of corporations which they deem to be of public interest. Analysts' research which is limited to the data set forth in the services may be superficial since the services' data are not necessarily complete. This was highlighted in the case of

Atlantic Research Corp., whose stock was suspended from trading by the Commission for several weeks in the fall of 1962.[247]

The corporation, which had a number of subsidiary corporations, distributed unconsolidated financial statements to the public during 1960, 1961, and 1962 showing substantial profits for the periods covered. Certified financial statements filed with the Commission on a consolidated basis as required under the Exchange Act showed that Atlantic Research sustained consolidated loses during the same periods. The difference appeared most dramatic in the earnings figures for 1961: The publicly released, unconsolidated statements showed a profit of $1,473,192, while those on a consolidated basis showed a loss of $1,066,015.[248]

Published data in the two statistical services were based upon the publicly released, unconsolidated statements. Neither examined the certified consolidated statements filed with the Commission. Standard & Poor's generally does not examine information filed with the Commission when it receives information which it considers satisfactory directly from the company, as it did in the case of Atlantic Research. Customarily it obtains information for its supplements to the Corporation Records from company releases, dividend information sent by the company, its own clipping service and checking New York Stock Exchange and Commission files when sufficient information is not otherwise available. It sends its annual revisions to the companies, in draft, for editing. Moody's, on the other hand, ordinarily checks Commission and exchange files on 500 large companies among the 4,000 upon which it reports, and for the balance (including Atlantic Research) relies on company releases, its clipping service, dividend information obtained directly from the companies and replies to its annual request for revision of information to appear in the new edition. In the case of Atlantic Research the request for revision concerning the company's 1961 operations was not returned, and Moody's relied solely on the company statement and data from its clipping service.

With regard to the broker-dealer adviser's interest in Atlantic Research, an analyst in the research department of Shearson, Hammill & Co., did check the statements filed with the Commission, noted the discrepancy and, on the basis of it, recommended, to several of its institutional clients only, that they sell the stock. On the other hand, presumably the several firms which during 1960–62 recommended purchase of the stock did not check the statements filed with the Commission. A principal of one broker-dealer firm which endorsed the stock has testified in this connection:

Q. Did you know that the company [Atlantic Research] had also filed annual 10–K reports?

A. Sure.

Q. Did you know what those reports would contain?

A. I would assume complete information. As to whether they were or were not available I don't believe I was cognizant of that fact.

Q. In other words, you depend upon information that is published in financial journals?

A. Yes, sir. You have to.

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[247] Securities Exchange Act release No. 6911 (Oct. 10, 1962).

[248] For the first 6 months of 1962, the unconsolidated statements showed a profit of $1,406.542 (unaudited), while the consolidated showed a loss of $473,079 (unaudited). Special report to stockholders, Nov. 9, 1962, p. 9.

Similarly, a recently reported survey of 198 analysts revealed that most of them "seldom" or "only occasionally" used such reports filed with the Commission as a major source of financial information.[249]

Where firms have correspondent and clearing arrangements with other broker-dealers, it is common for the major correspondent or clearing firm to make the services of and materials produced by its research department available to the smaller correspondents, who rely heavily upon it. For example, between April 1 and June 30, 1961, Clark, Dodge & Co., distributed directly 7,183 copies of its written advisory materials, and supplied another 40,281 copies to its correspondents. Another firm, Dominick & Dominick, had 18 American correspondents which used the facilities of its research department, consisting of 10 senior analysts, 5 junior analysts, and a fluctuating number of trainees for this and other departments of the firm. The correspondent firms had the right to request specific information by wire, telephone, and mail, and to distribute certain Dominick & Dominick printed material. Several types of this material sent by correspondents to their customers went out under the respective correspondent's imprint with no mention made of Dominick & Dominick.[250] All correspondents make heavy use of their right to secure wire information and advice from the research department; in the 2-week period from February 13 through February 27, 1962, a total of 602 such inquiries were answered.

While broker-dealers often distribute as their own the market letters and similar material of correspondent firms, the more common practice is to identify the correspondent and add the name of the distributing firm in a blank left for that purpose. However, a number of instances not involving correspondent firms came to the attention of the study in which broker-dealers distributed material prepared entirely outside the firm, with no indication of the material's origin. The value of such material is, of course, entirely dependent upon the quality of research and analytical work behind it. The head of Albion Securities Co., Inc., an over-the-counter house which engaged in underwriting and selling highly speculative securities and which had no research department, testified that his house often distributed market letters prepared by three or four firms "in the business of writing this type of letter for people in the securities business," [251] one of which firms was in the advertising business. None of the letters indicated the actual source. The practice of the public relations firm of DeWitt Conklin Organization, Inc., of preparing mailing pieces about its clients and supplying them to broker-dealers for mailing under the name of the broker-dealers, is discussed in the section of this report dealing with corporate publicity.[252] In some instances the distributing

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[249] Cerf, "Corporate Reporting and Investment Decisions," University of California, public accounting research program, pp. 14–15 (1961).

[250] Such publications furnished by a member firm to other member firms now must be identified as a publication of the originating firm. NYSE Guide, par. No. 2440A.10.

[251] Such business, with assurances of "complete confidence," is solicited in the following Wall Street Journal advertisement:

"PROFESSIONAL SERVICES. STOCKBROKER-DEALERS INVESTMENT MANAGERS. Your market letters expertly written. Special corporate reports and portfolio analysis prepared. Complete research package rendered by registered investment advisory and corporate consulting firm serving the investment profession exclusively. All inquiries held in complete confidence" (Jan. 9, 1963, p. 19).

[252] See ch. IX.C.4.

firm has little notion of the research effort used in the preparation of the materials.

On the other hand some wholesalers of advisory materials exert a serious effort to bring quality and reliability to their work product. One such firm is Argus Research, Inc., whose president and founder described the firm as representing "a cooperative research effort, permitting various securities firms to contribute to the central effort. * * *" Argus sells its advisory materials, with minor exceptions, only to broker-dealer firms and institutional investors.

The firm employs 12 research analysts, including 7 senior analysts and 5 junior analysts, maintains a large library, spending about $20,000 a year on statistical services, and considers field trips by analysts an essential part of each company study. It produces a weekly publication, the Staff Report, summarizing the more detailed individual studies which the research staff prepare and which are also available to subscribers requesting them. The Staff Report has a circulation of about 40,000 among Argus' clients (who pay an average of $200 per month for the Argus service) and their customers, to whom the report is distributed bearing both the Argus imprint and the name of the subscribing firm.

(2) *Internal variations in research practices*

A study of broker-dealer firms relatively well staffed with research personnel revealed, as has been suggested, wide variations in research standards applicable to differing research functions. To a certain extent these variations are inevitable, and, like overall research expenditures, reflect the varying degrees of potential profitability which firms attribute to the different activities to be served by the end product of their research.

An example of this economic valuation of research and the variations it produces is found in the operations of McDonnell & Co., Inc., a firm with 14 branch offices and 165 salesmen in early 1962. The firm has enjoyed a phenomenal growth. In about 5 years, the number of its employees increased from 80 employees to over 500. To a considerable extent the officers of the company attribute this growth to its successful use of research as a selling tool. At the time the firm was interviewed, it advertised "vital investment analysis (VIA)," a "hard hitting research approach," and based its sales effort as well as its substantial research department's activities upon its "25 percenter strategy," an avowed effort to recommend securities which offer an annual growth rate of 25 percent so that "your money can be doubled in 3 years."

Consistent with this approach, the firm's 23-man research department [253] concentrated on and closely followed some 120 to 150 securities, many of them traded over the counter. Some 70 to 80 percent of the research department recommendations to the firm's salesmen,

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[253] In spite of this firm's emphasis on research, by August 1962—after the precipitous market events of the preceding months—the firm's total research staff was reduced to as few as four persons. This cutback in research effort was not unique to McDonnell & Co. At that time others viewed research as "the most expendable activity" and, as was pointed out in an article in the New York Times—

"* * * The New York Society of Security Analysts, where membership has increased from 1,800 to 2,900 since 1951, reported it was having the hardest time in years getting jobs for laid-off members and others who use its placement service. * * * The New York Society of Junior Security Analysts, with a membership of 400, reported about 50 of its members were unemployed" (Aug. 11, 1962).

and in its several publications and numerous reports, concentrated on those stocks. While published sources of data and other recommendations were reviewed, analysts went to considerable effort to obtain reliable data from original sources. A report on A. C. Neilson Co. involved about 20 different personal contacts with the company's management, its customers, its competitors, and advertising agencies. A report on Del E. Webb Corp. was preceded by a 1-week trip of two analysts to Phoenix to talk to the company's management and banks, and by trips to Florida and New Jersey to see the operations of competitors.

The first beneficiaries of the firm's intensive research effort were the firm's institutional customers, for which it does considerable commission business. The research product was passed on to the firm's individual customers and those of its correspondents in abbreviated form and only after the institutional customers received the depth study. Opinions and recommendations of stocks not among the "25 percenters," necessarily reflecting a more modest research undertaking in many cases, also appeared in the firm's published materials and its considerable volume of internal teletype advice to salesmen.

Institutions are increasingly sought after as customers and this sort of priority treatment is prevalent among firms having such a clientele. Most of the firms having relatively well staffed research departments direct much of their effort toward institutional, or, as they are sometimes called, "professional" investors, such as advisers of mutual funds, trust departments of banks, managers of portfolios of pension funds, charitable institutions and insurance companies. As a senior partner of Kidder, Peabody & Co. said:

> * * * [we] do have a focus, quite a strong focus, of our business policy to better build our business by good research work and present effective investments. We particularly set our cap for the professional investor and the institutional investor for perhaps the basic business reason that we think [it] * * * has the biggest reward if one is successful.

Emphasis on this type of business is also shown by a Bache & Co. advertisement:

> * * * The recently established Bache & Co. Institutional Research Department is far more than a "research department." In effect, it is an organization within an organization * * * a group of top-flight specialists, fully equipped to handle the exacting demands of those who require the most detailed, exhaustive, and timely investment information.
>
> This department now serves some of the largest and most impressive names in the investment fraternity: banks, mutual funds, insurance companies, college endowments and pension funds.
>
> Do you represent such an institution? We would like to tell you how this special Bache & Co. service can provide in-depth studies and analyses to aid you in achieving prime investment objectives.[254]

The advisory material produced in the competition for institutional business is generally a detailed factual picture and evaluation of a particular security quite different from the specific "buy" recommendations of the market letter and teletype recommendation variety. When prepared, the reports are sent by firms courting such business to a select mailing list of institutional investors, though a relatively few copies may also be sent to individual customers. Where an institution shows interest, the report is often followed by a personal

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[254] Wall Street Journal (eastern ed.), Aug. 15, 1962, at p. 22.

visit from the analyst responsible for the report. When commitments based on the report are undertaken, the institution generally looks to that analyst to follow up subsequent developments concerning the issuer. It is common to find a very close working relationship between institutions and brokerage firms maintained by telephone, mail and visits, with a good part of the analysts' time spent in keeping the institutions up to date on developments in companies in which they have a commitment or are interested.

As has been indicated, the formulation of investment advice for internal distribution to salesmen and their customers is a major responsibility of most research departments. A review of research departments' internal communications which firms submitted to the study, and of the procedures that the examined firms followed with respect to such communications, provides some interesting comparisons and contrasts, both as to the published materials and the services supplied to institutional customers.

Inquiries from salesmen usually are received by teletype or telephone. The inquiries and the replies are rarely more than a sentence or two in length. In addition to responding to inquiries, internal teletype information is originated by the research department, sometimes in the form of "flashes" or brief news items about particular securities and others as advance notices of research reports to be released. Some firms also circulate internal printed materials consisting of market comments, reports on discussions at meetings of research personnel, views on particular securities, and reports on their activities as dealer and underwriter. Generally, such material, most of it captioned "Confidential," "For office use only," or "Not for distribution," is considerably more candid about the matters discussed than market letter material. Teletypes are freely used for sell and switch recommendations, both in appraisals originating with the research department and those solicited from it by the sales force. Unlike the written materials, management is often identified as the source of many of the views, in such statements as "management believes," "recent discussion with management," "our man at *x* company," or "have good source of information." In some firms a reply of "no opinion" is frankly given when the research department has none. Nevertheless, the very volume and brevity of the internal communications conveying recommendations, and the speed with which inquiries are answered, indicate the limitations on the depth of the underlying research, unless the security is one an analyst in the firm "follows"—a factor not disclosed and often not the case.

As a general rule, the most casual research effort in all firms was directed to portfolio review, which nevertheless, in most firms visited, was an integral part of the overall research activity and often advertised to attract new business.[255] As a representative of one firm noted, "There is something wrong with most everybody's list of stocks."

The information given the portfolio reviewer was typically limited. Rarely did he meet the investor. Often the basis for the review was limited to information filled out by salesmen or supplied on a card mailed to those responding initially to advertisements. Although the results of such portfolio reviews were often transmitted as impressive looking documents, in many instances they represented the work of the most junior members of the research department.

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[255] For a discussion of firms advertising such service, see pt. B.2.a, above.

5. THE SUBSCRIPTION SERVICES

A significant portion of the advisory materials offered to investors is produced by publishers registered with the Commission as investment advisers [256] who sell subscriptions to their services. Although in some respects this advice resembles that issued by broker-dealers, there are sharp differences in the purpose for which it is produced. Broker-dealer materials, as has been seen,[257] are primarily sales-oriented, designed to induce the recipient to become a customer of the distributing firm. Few subscription publishers, on the other hand, are in the brokerage business.[258] The economic benefits which they reap come simply in the form of paid circulation. Their subscribers therefore, who frequently pay rather substantial fees to obtain the advice, can reasonably expect a higher degree of expertness and impartiality. This is not always what they receive.

The volume of material circulated by the subscription advisers is not as vast as the broker-dealer output, but it is far from insignificant. Of the 1,836 investment advisers registered with the Commission on June 30, 1962, it is estimated that fewer than one-tenth published advisory materials at all, and even fewer published with regularity and with fair-sized circulations on a subscription basis. Circulation figures are hard to determine with accuracy, since they vary considerably from month to month often in proportion to market activity and the public participation therein. "Regular" subscribers are frequently substantially supplemented by those accepting "special introductory rate" offers. Value Line, a weekly publication with an annual subscription rate of $144, in 1961 claimed some 30,000 regular subscribers plus 10,000 to 15,000 additional readers through trial subscriptions. Other publications with large circulations during 1961 included United Business Service, with a weekly circulation of approximately 35,000, selling for $72 a year, the Dow Theory Forecast, with some 29,000 regular subscribers at a $60 annual rate, and Standard & Poor's Outlook selling at $65 a year with a weekly circulation of 33,300, and competing with its Investment Advisory Survey which had 18,000 subscriptions, also selling at $65 a year. More modest but still significant circulations were achieved by a broader group of publications including, for example, Moody's Stock Survey, which circulated weekly to approximately 6,200 subscribers at $144 a year.

The impact of market conditions on subscriptions is clearly shown in the circulation of most services. Investors Intelligence, for example, which digests the materials of some 70 investment advisory firms, slipped from a circulation of about 20,000 in the 1959 bull market to about 10,000 in the spring of 1962. The circulation of the Growth Stock Letter, published by Danforth-Epply Corp., declined

[256] Investment Advisers Act of 1940, sec. 202(a)(11) defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investment in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities," but excepts specified categories such as banks, "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receive no special compensation therefor," and "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; * * *."

[257] See sec. 4, above.

[258] See sec. 1, above. Some broker-dealers do publish materials available either on a flat subscription basis or in return for a specified minimum amount of brokerage business.

from around 10,000 in feverish 1961 to about 4,000 in the summer of 1962.

Although the total volume of the published material of subscription services is less than that produced by broker-dealers, the impact of subscription material is substantial, and may be far greater than even the impressive circulation figures suggest. This impact is not confined to the subscribers. The recommendations of the services are extensively recirculated by broker-dealer firms. Broker-dealers' market letters, internally distributed printed materials, and their internal teletype communications from research departments to salesmen, frequently quote the services and report their recommendations. In addition, many firms provide salesmen with reprint copies of publications of Standard & Poor's, Moody's, Argus Research, and other services for distribution to customers. One firm interviewed by the study distributed more than 8,000 pieces of material from Standard & Poor's during 3 months in 1961. Moreover, the salesmen of many broker-dealer firms on their own initiative subscribe to services for suggested recommendations.

A number of subscription publishers offer one degree or another of personal investment advice in addition to their publications. This group adds to the impersonal advice of their publications a means whereby the subscriber obtains advice to some extent tailored to his particular investment situation. These practices vary from the limited advice initiated at the request of the subscriber to personal portfolio guidance which approaches but does not reach the service provided by personal investment counselors.[259] The distinction from personal guidance was summarized by an official of United Business Service, which both publishes a service and handles investment counseling clients:

> The difference primarily lies in the area of initiative. The investment counsel client need exercise no initiative whatever. He has hired us as a personal investment counselor and it is up to us to worry about his or her securities and financial position throughout the life of the contract. The subscriber of the Business Service must himself or herself exercise the initiative.

Among the subscription services, which have so great an impact upon investor conduct, there is a striking diversity of views as to their responsibility to their respective subscribers. The head of one of the larger firms said, in discussing his publications, "We are publishers, not fiduciaries," although he indicated that his company felt a fiduciary obligation in the field of portfolio management or investment counseling. The head of another large service, when asked whether his service owed subscribers the same obligation of expert and careful advice as that owed to persons receiving personal portfolio management, replied: "The answer * * * is an overwhelming 'yes'." One publisher of a service of smaller circulation wrote: "Under our act [1940 Investment Advisers Act], the adviser is to regard himself as in a fiduciary relationship with his * * * subscriber." Another commented: "We are a news medium, and I think that is the extent of any obligation."

a. The advisory content of subscription publications

A subscriber to a subscription service generally receives 4 to 12 pages of printed material each week or, in some cases, biweekly or

[259] For a discussion of personal investment counseling for a fee, see sec. 6, below.

monthly. As compared to the advisory materials of broker-dealers, the subscription material reviewed by the study indicates on its face a greater diversity of research approach and content. The publications cover the spectrum, from those with a predominantly fundamental approach, through those avowedly combining or ambiguously referring to both fundamental and technical considerations, to those relying principally on a purely technical approach. The quality common to all publications, nevertheless, is that, as in the broker-dealer material, recommendations to buy particular securities are overwhelmingly predominant.

The group with a fundamentalist orientation is the largest, both in terms of number of publications and circulation of materials. It includes such well-known and widely distributed services as United Business Service, Babson's Reports, Standard & Poor's Outlook, Investment Advisory Survey and the Fitch Survey, and Moody's Stock Survey, as well as some publications of smaller circulation like Danforth-Epply Corp.'s Growth Stock Letter and Spear & Staff's Science and Electronics Investment Letter.

The typical publication in this group starts each issue with comments about developments affecting the economy generally, or those industries or groups of industries in which it purports to specialize (e.g., electronics and space industries), and with views of the current stock market situation. The bulk of each issue then is devoted to discussion and recommendations of specific securities. Some services state they are designed only for the investor interested in long-term investments, and these give a conservative tone to the content of their material. Others, concentrating on new fields like electronics where unseasoned companies abound, generally are less restrained in their comments. For example, notably colorful and florid language was regularly evident in the Spear & Staff's Science and Electronics Investment Letter.

In most issues, one or two of the recommendations are discussed at some length, with the balance of the issue devoted to briefer recommendations of other securities, usually a paragraph or two in length. A number of these publications give considerable attention to "supervised portfolios." As to the briefly recommended securities, the amount and nature of the information given in support of the recommendation is generally no different from that presented in most market letters, although the descriptions tend to be slightly longer. Adverse factors and uncertainties are sometimes described, but often the recommendations are as barren of such information as broker-dealer material, or reflect negative data in terms of risk in such general phrases as "speculative" or "businessman's risk." The supervised portfolios too are categorized in terms of general expressions of risk. A representative of one firm commented about the treatment of adverse factors and degrees of risk as follows:

> I think first of all we label them speculative if we feel they are. Secondly, we do point out the adverse factors. If we believe that the stock is a buy we obviously think that the favorable outweighs the unfavorable and, therefore, the writeup would emphasize the favorable. It would not omit the unfavorable.

As in the case of broker-dealer material, common stocks are generally featured. Despite the high price-earnings ratios of the 1961 bull market, these publications generally continued their strong

emphasis upon "buy" recommendations, without counsels of caution other than generalized market comment and rare suggestions that a partially liquid position should be maintained.

While predominantly recommending security purchases, the subscription publications do follow previously recommended securities, and even recommend sales, to a greater degree than the broker-dealer materials. Publishers' policies in this respect, of course, vary. Moody's Stock Survey and Danforth-Epply Corp.'s Growth Stock Letter, according to their publishers, undertake to follow each favorable recommendation until such time as a "sell" may be called for, though far less detailed and prominent treatment is given the "sells." On the other hand, for The Outlook, the Investment Advisory Survey and Fitch's Survey, Standard & Poor's follows only those recommendations which find their way to their "recommended lists." [260]

United Business Service leaves "sells" advice to the initiative of the subscriber:

> We don't, for example, say that we will recommend that you have Standard Oil of New Jersey and if we change our mind we will let you know. We don't. Everything is in answer to an inquiry from a client.

The officer in charge of advisory publications at one of the larger publishing firms, discussing the predominance of "buy" advice, emphasized the connection between the nature of the advice and subscription income. "We are publishers," he said. " 'Sell' advice won't sell." A "buy" emphasis is equally characteristic of the technically oriented publications.

A substantial number of the advisory publications, both technical and fundamental in approach, make a practice of highlighting one of their recommendations in each issue. This is done sometimes merely by the prominence and more extensive discussion given to the stock, and sometimes by presenting the "Stock of the Week" as in Standard & Poor's Outlook or the "Warrant for the Week" suggested in Investing and Management Compass, Inc.'s Warrant and Convertible Compass, one of the few publications emphasizing securities other than common stocks. The special problem which may be created by the market impact of these highlighted recommendations is discussed in section 7 below.

The subscription publications reviewed by the study did not reflect the almost universal reliance upon hedge clauses which was found in the broker-dealer materials. A few well-known publications bear no hedge clause at all, and those that do resort to language resembling the following:

> Information has been obtained from sources believed to be reliable, but its accuracy and completeness, and that of the opinions based thereon, are not guaranteed.

On the other hand, Moody's Stock Survey carries the following legend:

> NOTE.—Moody's Investors Service, Inc., has used due care and caution in the preparation of this publication. The factual information has been compiled from sources of repute, although not infallible. Errata, when discovered, are corrected. Opinions are based partly upon compiled factual information and partly upon other factors affecting our judgment of the matter treated. They are independent and unbiased.

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[260] Other "sells" may, on occasion, be given and the firm has recently indicated in its published materials a change of policy with respect to following all securities previously recommended for purchase until sale is advised.

Apart from Moody's declaration that their opinions are "unbiased," subscription materials of publishers are generally silent on the subject of publishers' positions in recommended stocks. Nevertheless, records of trading by principals and employees in several firms showed cases of ownership and even trading of recommended stocks without disclosing such fact in a hedge clause or otherwise.[261]

b. Research and services of subscription publications

The members of the research staffs of subscription publications are generally called upon to perform fewer functions than those assigned to the research departments of broker-dealers. Although, as has been suggested, a number of publishers offer personal services such as a consultation privilege and portfolio review, their staffs are free of the incessant inquiries of registered representatives. This is not to say, however, that they are free of pressures. The demand upon their time and energy to produce a continuing stream of new recommendations for their publications, combined with the demand for other services offered subscribers or other clients, may make careful security analysis difficult or impossible. In the case of advisory services, as in the case of broker-dealers, the study revealed extreme variations in the adequacy of staff and practices to perform the functions they purport to offer.

One of the more irresponsible patterns of research practices among the advisory publications which came to light during the study involved Dynamics Letter, which, as has been seen, was among those having a role in the Dunn Engineering Co. debacle.[262] Dynamics Letter's advertisements emphasized its study of fundamentals ("true raw stuff of planned capital growth") and its "technical and timing studies that indicated buying and selling levels." The publication also emphasized its "depth-research articles * * * that analysts and serious fact-seeking investors require." In its most prosperous days, it had a weekly circulation of 2,400, at an annual subscription rate of $90 a year, and was received by a number of registered representatives and some large brokerage houses. In 1961, the letter was written by its editor and publisher, Grant Jeffery, assisted on a part-time basis by his brother Peter. According to Grant Jeffery, the service "walked with two legs; one was charts, and one was news of a fundamental nature." Two part-time chartists, one of them employed full time at a New York Stock Exchange member firm, helped keep the firm's charts, which Grant Jeffery described as "a crystal ball for looking ahead." In addition to Grant Jeffery, who claimed to have "a very good connection with the business editors of electronic papers around New York and other science publications," two researchers studied "fundamentals" for the recommendations. One of these was Louis Hogan, whose background and lack of experience in security analysis

[261] See discussion at sec. 7, below.

[262] The Commission has ordered revocation proceedings under the Investment Advisers Act of 1940 against the publishers of Dynamics, upon staff charges that they engaged in fraudulent practices when among other things, "in recommending unseasoned and speculative securities particularly of eight specified corporations, [they] made false and misleading representations with respect to immediate short-term gains in the market price of such securities, the earnings of the issuers of such securities, and the business activities and prospects of such companies. Moreover, in continuing to recommend and discuss favorably such unseasoned and speculative securities following their original recommendations * * * they omitted to state certain material facts and adverse information concerning the business and earnings of such issuers and the market performance of their securities, which facts were known to them" (Investment Advisers Act release No. 137, Feb. 24, 1963).

has been described in connection with his recommendation of Dunn Engineering Co.[263] The other had previously been employed by a Madison Avenue advertising agency and as executive secretary of the New England Historical Society. In addition, Grant Jeffery had the part-time assistance of a consultant electronic engineer.

The Dynamics Letter often recommended from 30 to 40 stocks in each issue. Grant Jeffery conceded that it "would be impossible" to have been factually "on top of" all these stocks each week with the firm's limited research staff. Where frequently recommended electronic issues were concerned, much of the fundamental information was based on what Grant Jeffery could learn on the telephone from employees of trade publications. In other areas the "fundamentals" study was described in this manner: "I would say to him [Mr. Hogan, the researcher], in any given week, 'Now we are going to specialize on Fiberglas or whatever,' and he would get a list of all the companies in the field and write letters to them, correlate the information and come in and put it together, and then I would edit what he did * * *." Hogan described his end of this research activity this way: "They would submit material to us and I would go through this material and pick out what we would consider exciting information and write this up for the weekly letters."

The manner in which the weekly publication was produced was described in some detail by Grant and Peter Jeffery when examined by the study:

Mr. GRANT JEFFERY. We will take the example of what I am working on this week. I talk to so many people all the time and I am always looking for depressed areas, and I particularly put my head together in this connection this week with this Martin Orensoff, and [he] said what group is depressed now. Everybody is going to be talking about electronics this week because of the IRE show. We will cover it but let's talk about some other group. And he said that the building stocks are depressed right now. So I put Charlotte and Lou to work on the Standard & Poor's blue list that they have in their last volume of their six volumes, and they got in touch by phone, wire, and letter with every building entity that they could get hold of. The stuff has been pouring in from glass companies and tile companies and lumber companies. I, meanwhile, went to the public library and got several books on what life will be like in 1999, and so on, and descriptions of houses of the future. On Monday I put together an ad on that basis and turned it over to Peter, who puts the finishing Madison Avenue touches on our ads, and then as the week progresses I will ask our chartist again to pinpoint the stocks that are in the best position to buy. And we will take the most fascinating human interest detail of where the building business is going and say this is what the whole group can get into. And even though some of the news may come from a company who is not in a good buy position, it is very fascinating because it shows what the others can do. The specific buys that we recommend are such and such. And the letter as it is compiled during the week is twice the size of what finally survives because the most interesting stuff survives.

When I get back I will have to run for the IRE show for a couple of days, but during the course of Friday I will sift all of the material and put it into final form. And this will be mailed out over the weekend. And that is our letter.

Question. What did the flyers that went out ask for?

Mr. GRANT JEFFERY. They would simply say, "May we have your newest news on building developments for such and such a deadline." And the material comes right away.

Question. What about finances of the firms involved?

Mr. PETER JEFFERY. We have them all in the office.

Question. Who looks at the financials?

Mr. GRANT JEFFERY. Well, the matter of duplicating what the Wall Street Journal does in the way of statistical reporting is just not for us to do. We don't

[263] See discussion at sec. 3, above.

have the space. And our concentration is on the future rather than on the dead past of where the company has been.

The enthusiasm which their concentration on the future could occasionally generate is suggested by their recommendation of Universal Electronics Laboratories, Inc., in the March 24, 1961 issue:

There are only 75,000 shares of this stock in public hands; and since the issue came out a month ago at $4 it has attracted barely enough buyers to carry it to around $6 or $7. Based upon the rate of growth this company *must* enjoy, you'll be able to add at least a pair of zeros to today's price within as brief a time as a year or two. [Emphasis in original.]

It is no more true of subscription publishers than of broker-dealers that size of staff alone determines the adequacy of research practices. Among the publications of the services are a number of one-man operations, some of them prepared on a part-time basis, which received the study's attention. In one case, a monthly publication reviewing only one over-the-counter security in each issue, the staff and the research methods employed seemed adequate in relation to what the service undertook to do. This was not true of a number of others where the investment adviser recommended numerous stocks each week and, as was the case in several instances, provided other advisory activities as well.

On the other hand, in some cases the larger investment advisers provided sharp contrasts in approaches to research practices. Of the firms studied, Standard & Poor's had the largest research staff, consisting of 27 analysts, 12 assistant analysts, 15 field representatives (4 of them on a consultant basis), and 8 statisticians. Three of the company's vice presidents in charge of advisory services and research and seven of the editors of the various publications had been analysts. This research staff served the company's three weekly advisory publications, its daily Facts and Forecasts, its periodic Industry Surveys, and its three other publications which rate stocks (Listed Stock Reports, Stock Guide, and Stock Summary). The same staff also serviced the company's large counseling department which offers portfolio management on a fee basis. Analysts (but not the field representatives) were assigned on an industry basis, and relied heavily on information from field representatives and management interviews, supplementing such information from time to time with field trips of their own. In preparing a publication, the vice president in charge of the advisory service together with its editor tentatively outlined the industries and stocks to be mentioned several days before the press date, choosing their recommendations from the two or three "best buys" which each analyst was required to select regularly from the industries of his concern. Drafts were then prepared by the analysts for final editing.

While Standard & Poor's provides no special portfolio services for the subscribers to its publications, other publishers offer either an inquiry answering service or a portfolio review service or both. Babson's Reports had the most elaborate plan for bridging the gap between personal guidance and the impersonal device of a subscription publication in a single-priced service. For $156 per year, subscribers to the firm's one publication were expected to list their security holdings and other financial data with the firm, which prepared a "plan of action" for each subscriber suggesting a proper portfolio and ap-

propriate purchases and sales. In addition, the firm's 12,000 subscribers were encouraged to report all purchases and sales to assist the firm in maintaining its list of approximately 1,400 securities. The firm advertised that it kept "a day-to-day watch" on the listed securities and undertook to give notice to subscribers where circumstances warranted change for any security. It also advertised extensively its "personal consultation privilege" which could be availed of by phone, letter, or in person. Finally, day-long Chatauqua-type "annual investment conferences" were held in several places throughout the United States each year, to which subscribers in the general area were invited to hear talks on investing and to consult briefly with firm representatives.

The firm's "plans of action" submitted to new subscribers were prepared by one analyst who turned out about nine a day. Ten consultants handled subsequent inquiries by mail, phone, or in person. The firm's regular weekly report, monthly Speculative Situation report, Company Reports, Buy Stories, and Special Notices were prepared by seven analysts who also helped the consultants in their individual consultations when necessary. In addition, the seven analysts together were expected to follow daily developments in the 1,400 securities and each was expected to have a "buy," "sell," or "hold" opinion on all stocks assigned to him.

A fundamental approach to research was followed by the firm and, unlike most other investment adviser publications, it depended for new subscriptions less on advertising and direct mail solicitation than on an aggressive force of 30 outside salesmen.

As was the case with broker-dealers, the publications of investment advisers relied in varying degrees on research materials obtained from outside sources. At Danforth-Epply Corp., for example, the editors and analysts, who supplied the research and also handled the discretionary accounts of the firm's portfolio management clients, were able to secure information and advice from analysts at Smith, Barney & Co., including data obtained through field trips by the Smith, Barney analysts.

Of some concern in this respect is the apparent reliance by some registered investment advisers on less reliable freelance investment advance. A recent field inspection by the Commission of one publisher revealed that the firm's weekly publication, with over 1,000 subscribers, was prepared in its entirety and mailed by an outside, independent contractor, for $75 a week. Another used individual freelance articles and paid $200 for each article published. The Drourr, Lampert subscription publication, the Growth Specialist, which has already been referred to as part of the Dunn Engineering situation, was prepared on the outside by an individual who admittedly did not understand the charts he used, and for fundamental data on occasions relied on incomplete and out-of-date information.

Other subscription publishers, in an effort to shortcut the research and analysis problems involved in keeping track of the many stocks they undertake to follow, have turned to the use of computers and data-processing equipment. Such equipment no doubt does and will increasingly serve as a valuable aid in security analysis, particularly in the rapid screening of comparative data. It is a cause for concern,

however, when the advisers claim or even suggest that it is anything more than a timesaving aid to the analyst.[264]

c. The advertising of subscription publications

Like broker-dealers, investment advisers with subscription services are continuously seeking new customers. With a subscription lapse rate which may average 50 percent or more, they must constantly add new subscribers to their lists, and efforts toward this end constitute a substantial cost to many firms and, for some, absorb the majority of their budget. Sometimes this takes the form of personal contact by sales personnel. More commonly, however, the publishers rely exclusively on magazine and newspaper advertising and particularly on direct mail solicitation. Substantially all publishers interviewed stated that they rent lists of names from numerous sources, including list brokers and other subscription publications. Names on a list may command a price of 20 cents for new names with lower rates for older names. One firm rented a list consisting of several hundred thousand names.

One characteristic common to most subscription publisher advertising and solicitation material, particularly during the bull market in the spring of 1961, was its sensational and even frenzied approach. Some appreciation of the nature and proportion of this activity can be had from a brief review of the advertising and solicitation campaign of Spear & Staff during a 3-month period in 1961.

The firm's advertising, like most by advisory publishers, was largely designed to sell trial subscriptions to one of the firm's five advisory publications. As a special inducement, the reader was offered a "special report" affording him special opportunity for gain. The tone of both space advertisements and soliciting letters was set by the "lead" which in a sentence or a phrase refers to this special report.

Spear & Staff, during a 3-month period in 1961,[265] ran 22 advertisements for its Market Letter, on 48 days in 87 newspapers and magazines, bearing such captions as the following:

100 Point Rise by Summer.
4 Awakening Sleepers for Large 1961 Gains.
100 Point Rise by Fall.

During the same period it used 63 different mailing pieces in direct mail solicitations. These also featured such leads as:

Can the "Dow" Double Again in the "Sixties"?
The 1,300 Level—A New Bull Market Objective?
5 Low-Priced Stocks Set To Surge Up in the Next Big Rise.
3 More Stocks To Ride the Crest of the Little Publicized *"Hidden Bull Market"* in *Specialty Stocks, Now Selling Under $30 With 18-Month Profit Objectives of 50 Percent to 100 Percent.* [Emphasis in original.]

Approximately 482,165 separate mail-solicitation pieces were mailed during the 3-month period.

During the same period the firm's Science and Electronics Letter was offered in 14 ads, on 29 days, in 35 newspapers and magazines, with leads such as:

4 Electronic Stocks Likely To Rise on Soaring Earnings.
How Much Higher Can Electronic Stocks Go?
$1,000 to $29,443 in 2 Years With One "New Science" Stock.

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[264] One such firm soliciting new subscribers claims that its use of computer research "* * * *makes possible* a precise, reliable method of forecasting market swings and individual stock prices * * * *before they occur.*" [Emphasis in original.]
[265] Apr. 1 to June 30, 1961.

This service, in addition, used 53 separate mailing pieces, with an estimated total mailing of 621,871 letters. These contained even more sensational headlines, such as:

> 3 Overlooked Electronic Stocks for "Explosive" 1961 Profits.
> *History-Making Discoveries by Low-Priced Science Stocks Can Miraculously Bring Fortune-Building Profits Within Your Reach!*
> *3 Strong Science Break Through Stocks for Potentially Explosive Profits.*
> *Is This $12 "Mystery Stock" Another "Space-Age" New-Issue That Will Surpass the Gain (12 to 93, Then Split 3-for-1) in Cubic Corporations?* [Emphasis in original.]

In addition, 527, 902 "special situations reports" were mailed in the same period, using similar leads.

The use of such language was by no means restricted to Spear & Staff. For example, another firm, Dow Theory Forecasts, used the following headlines in the same period:

> Stock Market Crisis Within Next 30 Days.
> Stock Boom Coming in Next 30 Days?
> 22 Stocks Likely To Split Before June 1.
> 22 Stocks Likely To Split Before August 1.
> 3 Stocks To Buy Before April 14.
> 3 Stocks To Buy Before May 1.
> 4 Low Priced Stocks for a Fast Move!

The impact of such advertising is apparently considerable, and thus a cause for concern. As the head of one advisory firm stated: "The advertising of the investment advisory community seems to me to be the biggest evil." In the words of a second, "* * * the public can't resist this kind of stuff." The head of a third firm told the study that "florid" advertising tends to "keep the fire going" in a period of "speculative frenzy," but stated that his own firm was compelled by competitive necessity to resort to it. The category of investor who responds to this type of advertising was described by one investment adviser in the following way:

> * * * [T]he people that are investing funds are those that were saving for their kids' college education investing in hot issues hoping to double and triple—the old greed.

This description is perhaps borne out by the experience of one subscription service, the Drew Odd Lot Studies, which, during the same period, drew a complete lack of response after running in Barron's a full-page ad headlined: "If you want to make a fortune in the stock market quickly—don't send $1 to us!" The text began: "Frankly, it will be a waste of your dollar. This is one service that does not have an interminable supply of red-hot tips * * *."

A basic problem caused by such advertising and solicitation is its effect upon the form and content of the published advice itself, which must, of course, satisfy the expectations which have been created. Often the same tone, leads, and cliches appearing in the advertisements are found in the text of the research reports offered. Such flamboyant coloring of the analyst's research product can only tend to undermine the integrity of his efforts.

In 1961, the Commission promulgated rule 206(4)-1 under the Investment Advisers Act, restricting certain advertising practices,[266] which is discussed in section 8 below. A review of the current adver-

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[266] Investment Advisers Act release No. 121 (Nov. 2, 1961). Effective Jan. 1, 1962. See also Investment Advisers Act release No. 113, Apr. 4, 1961.

tising practices of subscription publishers reveals that their tone has indeed been quited. However, the extent to which this is due to the Commission's advertising rules or to the relative abatement of speculative fever since the May 1962 market break, remains to be determined.

6. PERSONAL INVESTMENT COUNSELING FOR A FEE

The investor with a portfolio of considerable value (usually $50,000 to $100,000 minimum) who prefers not to make his own investment decisions may for a fee have his portfolio managed for him. Providing such investment supervisory services, defined in the Investment Advisers Act as "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client,"[267] is an important activity of many of the registered investment advisers who were surveyed by the study.

The affluent investor, whether an individual, a trustee, or an institution, can turn to any one of several sources for investment supervisory services. Many brokerage firms offer special portfolio management services for a separate fee. At least one firm provides such services without charge. In addition, many subscription publishers have a separate "counseling department." Finally there is a large group of investment advisers who confine their activities solely to giving investment counsel,[268] ranging from a few larger firms to a substantial group of smaller firms.

Whichever source of special portfolio management he may use, the investor finds a fairly consistent pattern of operation among the larger firms. For the typical investment counseling firm, his account is assigned to a particular "counselor" or "account supervisor," who usually is a mature, experienced person devoting his full time to the management of the portfolios under his supervision. The investor gives the account supervisor considerable detailed information concerning his financial situation and investment objectives. The account supervisor maintains personal contact, by phone, letter, and in person. It is the duty of the account supervisor to select appropriate securities for the portfolio, in most firms from an "approved list" although in occasional situations departures from the list may be permitted, and to follow closely and recommend changes in the portfolio holdings. The approved list is based upon research and recommendations by analysts in the firm's separate research department, and is approved by a committee which generally includes the heads of both the portfolio management department and the research department. It is not the job of the account supervisor to engage in research and originate investment suggestions, but the analysts who do perform those functions are available for consultations. Apart from brokerage firms providing investment supervisory services, few investment counseling firms have custody of clients' funds or securities,

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[267] Investment Advisers Act, sec. 202(a)(13).

[268] Under sec. 208(c) of the Investment Advisers Act it is unlawful for any registered investment adviser to represent that he is an investment counsel or to use the name "investment counsel" as descriptive of his business unless his principal business is acting as investment adviser and a substantial part of his business consists of rendering investment supervisory services. Firms principally engaged in brokerage business do not, of course, qualify as investment counsel. Publishing firms, if their investment supervisory service business is "substantial" can hold themselves out as investment counsel. Persons engaged solely in investment supervisory service generally describe themselves as investment counsel.

or take any part in the execution of recommended transactions, although in some cases arrangements exist under which the client authorizes his broker to act on the instructions of the account supervisor.[269]

There are a number of smaller advisers offering personal investment counseling, ranging from partnerships and corporations with several principals to one-man corporations or firms. Information with respect to a number of these, available in the reports of the Commission's field investigations, showed more variation in practices than is true for the larger advisers. Some are well-established firms with substantial sums under management, and operate much as do the larger firms already described. At the other extreme, counseling is a part-time "hobby" for a few. Several stated that suitability of investments for their clients was not their concern, and limited their attention to general statements of investment goals. A number had custody of funds and securities. Trading practices of the advisers also varied. Some did not purchase the stocks they recommended, while others consistently did so, buying and selling for their own accounts before giving recommendations.

No uniformity was apparent in the fee arrangements for investment supervisory services provided by firms, whether large or small. Some counseling firms negotiate fees on the basis of time; some have fixed schedules geared to asset values. Some brokerage firm arrangements resemble those of the counseling firms; others are linked to commission income realized on portfolio transactions either by an addition to the commission, or by reducing the fee charged by the amount of the commissions.

Some of the investment advisers not associated with brokerage firms or subscription publications have joined together to form an association, the Investment Counsel Association of America, for the purpose, among others, of promoting "integrity, public responsibility, and competence in the professsion of investment counsel." Membership in the association is limited to firms "primarily engaged in the giving of continuous advice with respect to the investment of funds of their clients on the basis of the individual needs of each client." By definition, therefore, brokerage firms and subscription publishers are excluded. As of June 30, 1962, membership in the association numbered 54, and this fact together with the exclusion of broker-dealers and subscription publishers limits its impact on the general standards of the investment advisory community. Nevertheless, the statement of "function and principles" adopted by the organization, reflecting as it does one industry group's views of their function, provides an interesting yardstick against which to measure the conduct of the industry as a whole. The most pertinent provisions of the statement read:

> It is the function of the profession of investment counsel to render to clients on a personal basis competent, unbiased and continuous advice regarding the sound management of their investments * * * neither the firm nor any partner, executive or employee thereof should directly or indirectly engage in any activity which may jeopardize the firm's ability to render unbiased investment advice.
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[269] One exception to this generalization is the firm of Danforth-Epply Corp., which accepts only discretionary accounts and itself directs all executions through the brokerage firm where all of the advisory accounts are maintained.

To serve its clientele effectively and continuously all of the partners and or principal executives of an investment counsel firm should be individuals of demonstrated investment ability and unquestioned integrity; and the firm should maintain adequate capital and reserves at all times. * * *

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Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered, and should not be contingent upon profits, upon the number or value of transactions executed, nor upon the maintenance of any minimum income.

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The methods employed and all written or oral statements made by an investment counsel firm in securing new clients should conform to standards consistent with the professional nature of investment counsel services.

7. CONFLICTS

An examination of the activities of investment advisers raises serious questions of whether their legal and ethical responsibilities to those who receive their advice are fully met. On the one hand, investors expect at least that the advice they receive will be not only responsibly prepared but also impartial—or, if there be any basis for bias, that this will be disclosed. On the other hand, because of the conflicts of many advisers, the results of the Special Study's findings indicate that this may not be what they receive.

Bias is most obviously evident and most inconsistently treated by the industry where investment advice concerns securities in which the adviser or his employee has a position. Some broker-dealers have stated, for example, that where they are about to recommend an unlisted stock which has a limited floating supply, they will intentionally build up a position before making the recommendation. Their purpose in doing so, they state, is to have the stock available for customers at a price which will not reflect the market impact of the recommendation. Presumably such advance accumulation involves no improper motives. Other firms making a market in an over-the-counter security may stimulate interest in the security by recommending it in materials sent their own retail customers and to others in the business. Indeed, some firms distribute only literature concerning securities in which they are making a market, sometimes indicating in the materials that they are dealers in the stocks, and sometimes not.[270] A partner of one firm, commenting on the constant effort of his research department "to ferret out worthwhile over-the-counter situations," noted that, when successful, his firm took a position in the stock, and added:

When we do this, we write a letter about this particular stock and distribute this letter to all dealers who participate in this service. They are all pleased with the opportunity of getting a carefully prepared analysis of different situations to distribute to their clients, wherever they may be.

Various firms interviewed by the study follow the practice of the analyst of Sirota, Taylor & Co.[271] In using advisory materials to aid in liquidating firm positions. These positions may have been acquired as investments, as underwriter's compensation, or as a trading inventory. In their internal research department communications, firms making markets also emphasize the stocks in which the markets are

[270] For an example of this practice see the discussion of the report of Equitable Securities Corp. in sec. 4, above.

[271] See discussion in sec. 3, above.

made, with comments ranging from information on new developments, management statements and predictions to emphatic endorsements such as the flash of Courts & Co.: "Think you boys should crank up on it [a stock in which the firm made a market] as consider it very attractive * * *." Speaking generally about the conflicts of broker-dealers in such situations, the head of one publishing firm said: "Ownership tends to make errors on the bullish side." Broker-dealers questioned by the Special Study showed no consistent views on the propriety of recommending securities in which the firm is disposing of its position, or on the necessity of disclosing that it was doing so. Some firms take the strictest view, saying that they will not even solicit purchases by their public customers of any such security. Others say they will not prepare a market letter or research report on a security in which they are liquidating an investment position.

While advisory recommendations of securities in which a broker-dealer has a position may, in most instances, simply raise the problem of inherent bias, there are some cases which go to the basic question of good faith. It is generally conceded by publishers and broker-dealers alike that any recommendations of an advisory service with a sizable circulation could have at least a short-term effect on a stock's market price. A broker-dealer, publisher, or employee of either, who knows of a pending recommendation and buys the stock before the recommendation, and then sells after the market price has felt its impact, is engaging in a practice known to Wall Street as "scalping." Evidence of scalping was found by the Special Study, both among brokers and among registered investment advisers.

The New York Stock Exchange member firm of Stearns & Co. was the publisher of a weekly market letter with a circulation of some 7,500, known as the Gutman Letter after its author, Walter Gutman, an analyst, registered representative and registered investment adviser employed by the firm. The letter customarily recommended various stocks, many of which were volatile over-the-counter issues, and the study revealed that on several occasions partners of the firm, as well as employees, family members, and discretionary accounts handled by registered representatives, made purchases of a security on or immediately before the day on which it was recommended in the market letter, and sold it at a profit a day or so thereafter. One such instance involved the stock of U.S. Photo Supply Corp., which in August 1960 made a regulation A offering of 120,000 shares at $2.50 per share. During the week commencing December 18, 1960, the stock was brought to the attention of Gutman, and was written up as a recommendation in the Gutman Letter of December 20, 1960, which reached the public on December 21 and 22. The firm's trading records show purchases on December 20 by the wife of a partner, the wife of a registered representative who subsequently became a partner, and two discretionary accounts of Gutman's, all at prices of 5¼ to 5½, and sales by these accounts between December 21 and January 3 at prices ranging from 8⅛ to 17.[272]

The Special Study also found evidence of undisclosed purchases and sales of favorable recommended stocks in the period before and following the release of publications of an investment advisory firm.[273]

[272] Action taken by the exchange in this matter is discussed in sec. 8, below.
[273] See also *S.E.C. v. Capital Gains Research Bureau, Inc.*, 300 F. 2d 745, 306 F. 2d 606 (en banc) (2d Cir., 1962), cert. granted, 31 U.S.L. Week 3233 (Jan. 21, 1963), discussed in sec. 8.b, below.

For example, examinations of the brokerage accounts of officers and editorial and advisory personnel of Spear & Staff revealed numerous instances of purchases just prior to favorable recommendation in one or more Spear & Staff publications, and, in some cases, their sale shortly after recommendation. One instance involved the recommendation of Computer Systems, Inc. The stock was a featured recommendation in the April 14, 1961, issue of the Science and Electronics Investment Letter, received favorable comment in the April 28 issue, and was again strongly recommended in the May 26 issue. Also, in the 3-month period of April 1 to June 30, 1961, it was recommended in 21 separate and intensively advertised "Special Reports" sent to trial subscribers. One officer bought the stock on April 4 and April 20 and sold on May 5; another, an associate editor, bought on April 7 and April 14 and sold on April 27. The firm has a written policy against "attempting to capitalize * * * on our recommendations," but trading is not reported or checked.

Many of the broker-dealers and subscription publishers questioned by the Study staff have firm policies prohibiting both the disclosure of recommendations in advance of release and trading on the basis of such recommendations. A few, such as Dominick & Dominick and Edwards & Hanly, concentrated on securities with large floating supplies, where they assumed that the market impact of their recommendations was minimal, and considered such firm policies unnecessary. McDonnell & Co., on the other hand, which concentrated on "growth stock" issues and estimated that the combination of its recommendation and vigorous selling efforts could "easily stimulate a 50,000 share demand in any security," prohibited its officers and employees from trading in any security known to be the subject of a forthcoming recommendation for the 48-hour period following its distribution. Similar rules restricting trading were in effect at some subscription publishers including Standard & Poor's and Moody's.

The efficacy of such trading prohibitions to cope with the problem of scalping must ultimately depend on the alertness and vigor with which they are enforced. While inspections by the Government or by self-regulatory organizations may uncover an occasional instance, it is clear that those engaged in publishing recommendations must be the first line of public defense.

Another problem which can grow out of the public impact of investment advice involves a conflict not between the disseminator of advice and his customers or clients, but among various categories of his clients. The legal and ethical responsibilities concerning this problem, and the attitudes of the investment community toward it, are even less clearly defined.

In view of the generally conceded ability of a broadly distributed recommendation to cause a market increase or decline of a few points in a security, the customer who learns of the recommendation before it becomes public seems to have a clear advantage. The ethical propriety of making recommendations available in advance to favored classes of clients is a matter of some difference of opinion, particularly in the brokerage community. As has been seen, a number of brokers deliberately make the fruits of their most painstaking research efforts available to a select group of institutional customers or potential customers before publication.[274] Some brokers claim, however, that

[274] See discussion in sec. 4, above.

the "bulge" effect of a market recommendation is so evanescent that the category of customers receiving the recommendation at a later stage is not, in fact, injured by the earlier disclosure of the recommendation to institutional clients. In fact, some state they deliberately delay release of market letters until the effect of institutional buying has worn off.

As to "sell" advice, some broker-dealers, rationalizing their disinclination to publish recommendations to sell, voice concern for their ethical responsibility and possible legal liability to those customers who might receive the advice later than other customers. On the other hand the study found evidence of firms giving "sell" advice to a limited group of institutional clients, while failing to make such advice available to their customers generally.[275]

Favoritism among categories of clients is also evidenced by conducting more intensified research efforts for institutional clienteles.[276] This practice is not, however, universally followed. For example, Smith Barney & Co., as has been noted, states that it makes the same research reports, favorable or unfavorable, available to all customers and registered representatives simultaneously.

At chapter III.F below, a related problem of potentially conflicting interests—that involving broker-dealer representation on boards of directors of issuers whose securities are recommended for purchase or sale—is discussed. This is a problem apparently largely limited to the broker-dealer side of investment advice; the subscription publishers questioned by the study staff universally stated that their principals held no board positions on publicly held corporations, and the same was true, with very limited exceptions, of the firms doing only personal investment counseling.

8. EXISTING CONTROLS OVER INVESTMENT ADVICE

As chapter II points out, the investor gets little protection from existing controls governing entry by persons and firms into the business of preparing and distributing investment advice. This section will consider the existing regulatory controls relating to the form and content of investment advice and the manner in which it is produced and disseminated. In reviewing the latter group of controls, the differing problems and controlling agencies involved dictate a separate consideration of those affecting broker-dealers and those affecting registered investment advisers. The regulatory agencies primarily concerned are the Commission, the NYSE, and the NASD. State controls with respect to conduct in the investment advisory field are of extremely limited scope and significance in coping with the problems raised by those who furnish investment advice.[277] The regional ex-

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[275] See, e.g., discussion of Shearson, Hammill & Co. advice in connection with Atlantic Research Corp. in sec. 4, above.

[276] See discussion in sec. 4, above.

[277] As noted in ch. II, the blue sky laws of several States provide for registration of "investment advisers" and "investment counselors," and in some instances impose special requirements. Their conduct is generally regulated under the same fraud concepts applicable to broker-dealers. A few States have statutes or regulations directly addressed to advisory conduct. Three prohibit assurances that an investment is safe. Four regulate the use of "comparisons." Alabama imposes an undefined "fiduciary obligation" upon those offering investment advice. Three require disclosure of position in securities recommended. Interestingly, the Uniform Securities Act contains a provision which conditions registration of a broker-dealer who is not found to be qualified as an investment adviser, upon his not transacting business as an investment adviser (sec. 204(b)(5)).

changes have generally adopted rules patterned on the NYSE controls, but the limited activities conducted in this area by their sole members make the enforcement of these rules a minor part of their regulatory programs.

a. Controls over broker-dealer conduct

The controls over oral investment advice given by registered representatives have already been discussed in the framework of selling practices.[278] This section, therefore, deals principally with the printed investment advice disseminated by broker-dealers. Whatever its caliber, such advice is essentially sales promotion material. Whether the investor realizes this or not, it is generally recognized and treated as such for regulatory purposes.

(1) *Federal controls*

From the point of view of the Commission, Federal regulation of advisory material is based upon the antifraud statutes and regulations which, with court and Commission gloss, encompass conduct far broader than was considered fraudulent under common law concepts. The fraud rules are found in section 17(a) of the Securities Act, sections 10(b) and 15(c)(1) of the Exchange Act and rules 10b-5 and 15c1-2 adopted under the Exchange Act. According to the Commission:

> The Federal securities laws are the result of congressional awareness that securities are "intricate merchandise," and that intelligent investment decisions require evaluation of complex and complete information concerning the security involved. Congress recognized that fair dealing in securities required that investors be afforded protections not only against false and misleading statements but against all sharp and inequitable practices devised by men with "acute, active minds, trained to quick apprehension, decision, and action." [279]

A broad application of the foregoing language to investment advice might be expected to eliminate many of the questionable practices connected with it. In 1963, the Commission, in the case of *Heft, Kahn & Infante, Inc.*,[280] for the first time explicitly focused on the responsibilities of a research analyst who, pursuant to the instructions of his employer, prepared a false and misleading market letter for distribution to the public, although he knew there were no supporting facts, and held that he was "an important part of an apparatus perpetrating a fraud." The Commission has also held that predictions, projections, and optimistic forecasts made without reasonable basis may constitute fraud,[281] and has referred to the representation that the customer will be dealt with fairly in accordance with the standards of the profession.[282] In discussing printed advisory material which contained "false and misleading statements," the Commission has also expressly commented on "the duty owed to investors to make accurate and adequate representations" and "diligent inquiry." [283]

These cases would seem to suggest that the Commission would regard it as unlawful for any broker-dealer to distribute a market letter as part of a sales promotion program which (*a*) makes exaggerated or unsupported predictions of prices or earnings, (*b*) omits material

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[278] See pt. B, above.
[279] *Mac Robbins & Co., Inc.*, Securities Exchange Act release No. 6846 (July 11, 1962).
[280] Securities Exchange Act release No. 7020 (Feb. 11, 1963).
[281] *Mac Robbins & Co., Inc.*, Securities Exchange Act release No. 6846 (July 11, 1962).
[282] *Duker* v. *Duker*, 6 S.E.C. 386, 388–89 (1939).
[283] *Investment Service Co.*, Securities Exchange Act release No. 6884 (Aug. 15, 1962).

information, including the basis, whether technical, a study of fundamentals, or both, of predictions, or (c) implies that the broker-dealer has an adequate research staff when such is not the case.

The principles articulated by the Commission are applicable to all broker-dealer selling literature. As a practical matter, they have been invoked principally in securities sales cases involving boilerroom activities, and then in conjunction with a number of other undesirable practices.[284] In its administration of the securities laws the Commission makes no concerted effort to police the preparation of sales promotion material of the broker-dealers subject to its jurisdiction. Although it requires that sales and advertising literature of broker-dealers and registered investment advisers be preserved for 6- and 5-year periods, respectively, and kept in an easily accessible place for the first two,[285] its inspection program lays no particular emphasis on policing this aspect of the securities industry. Except for the boilerrooms, surveillance, and enforcement of standards for investment advice of broker-dealers are left largely to the self-regulatory agencies.

(2) *The NYSE*

Since printed investment advice distributed by its member firms constitutes the major part of such advice distributed to the public, NYSE controls are of special importance. While the exchange divides such advice into the categories of "market letters" [286] and "sales literature" [287] it applies the same standards to both. They are, in addition, the same standards as the exchange applies in judging member firm advertising.[288] The general principles governing such material are, in the language of the exchange, "truthfulness and good taste." [289]

Rules, the exchange points out, "can never take the place of good judgment in the preparation of advertising, market letters, and sales literature. Under some circumstances what is left out may be just as important as what is included." [290] The exchange supplements this broad generalization of its standards with "guideposts followed by our community" of which the following is part:

(1) *Recommendations.*—In recommending the purchase, sale, or switch of specific securities, supporting information should be provided or offered.

If a member organization recommends a security in which it has a substantial position, or has some special relationship with the issuer—such as being consultant for a fee—it should consider whether such interest or relationship ought to be stated in the material.

(2) *Projections and predictions.*—Past records, charts, tables, or other materials cannot, of course, be used to promise future profits or income from securities.

Forecasts of future performance of a security, or of the market generally, should be clearly labeled as opinion.[291]

In February 1963 these were further supplemented by additional criteria of practices to be avoided:

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[284] E.g., *Heft, Kahn & Infante, Inc.*, Securities Exchange Act release No. 7020 (Feb. 11, 1963).

[285] Exchange Act, rule 17a-4(b)(4); Investment Advisers Act, rule 204-2 (a)(11) and (e)(1).

[286] "* * * [A]ny publication * * * which comments on the securities market or individual securities and is prepared for distribution to the organization's customers or to the public" (par. No. 2472.10, NYSE Guide).

[287] "* * * [P]rinted or processed reports or analyses covering individual companies or industries; leaflets or booklets interpreting the facilities offered by a member organization * * * to the public; discussions of the place of investment in an individual's financial planning; and * * * material calling attention to the foregoing * * *." Ibid.

[288] NYSE Guide, par. No. 2474A.10.

[289] Ibid.

[290] Ibid.

[291] Ibid.

1. *Language* which is promissory, exaggerated, flamboyant, or contains unwarranted superlatives.
2. *Opinions* which are not clearly labeled as such.
3. *Forecasts* of future events which are not stated as estimates or opinions.
4. *Comparisons* which are misleading or irrelevant to investing or to specific securities. [Emphasis in orginal.] [292]

From the study's review of member firm advisory materials, however, it is hard to escape the conclusion that a fair number of such firms have paid little attention to the "guideposts" of their community. A number of member firms circulated materials, especially market letters, with recommendations which lacked either supporting information or any offer of it. If most firms "consider" including statements of their interests in recommended securities, the results of such consideration appear almost universally to be negative, unless the unrevealing hedge clauses discussed above are thought by the firms to constitute such statements.[293] The common forecasts of future performance in member market letters are of necessity expressions of opinion, but it can hardly be said that most are clearly labled as such.

Since November 1, 1955, when the exchange, after a conference with the Commission adopted rules relating to market letters and selling literature, it has required approval of all such material by a member or by a general partner or voting stockholder of a member organization, and has required member firms to retain such material for at least 3 years, for inspection by or delivery to the exchange.[294] Responsibility for administration of the exchange's review of this material is vested in the advertising and promotion department of the public relations and market development group, a service department with no regulatory duties other than this review.[295] The exchange staff currently engaged in this review includes four employees; until October 1961, one employee performed it part time. The department requests member firms to supply market letters every 6 months; until October 1961, they were reviewed once every 2 years. The request covers all such material distributed in a specified period, usually 1 week. Occasionally, however, market letters regarded by the exchange as troublesome are kept under constant surveillance.

The exchange staff reviews printed advisory materials in the light of its announced standards of truthfulness and good taste. The exchange expressly disclaims responsibility for the accuracy and completeness of factual information appearing in member firm advisory material; it is concerned with the manner—or form—in which information and opinions are presented [296] and considers that its standards are complied with when it ascertains the member firm relied in good faith upon a source of information thought to be reliable, such as company management.[297]

So far as it goes, the exchange review program performs a valuable function. For example, a partner of Irving Weis & Co. was advised that material prepared by his firm contained a prediction of the

[292] P.R. & M.D. Educational Circular No. 2, Feb. 21, 1963.
[293] See sec. 4, above.
[294] Rule 472.
[295] The stock watching section of the department of member firms also reviews market letters in the course of its functions, but its concern is principally with their impact on the market price of securities. The exchange recently established a separate unit of advertising and market letter review.
[296] NYSE Guide, par. No. 2474A.10.
[297] See NYSE reply to complaint about Filor, Bullard & Smyth market letter on Dunn Engineering Co., discussed in sec. 3, above.

future stated as a fact. Philips, Rosen, Appel & Walden was informed that it should not send "trading" reports to unknown persons advising short sales without warning the reader that short selling is a specialized investment technique which should not be used by those unfamiliar with it. Cohen, Simonson & Co. was told that it could not state, after recommending the purchase of six securities, that "[t]he foregoing information is not to be considered as a buying or selling recommendation nor as a solicitation," [298] and that an offer of additional information on the securities must be made.

On the other hand, considerable effort is expended over what appears to involve trivial matters of taste. The exchange's concern with the Gutman Letter, it may be noted, was "generally in the area of good taste." For example, the exchange took exception to Gutman's description of its "Own Your Share of American Business" campaign as "the people's private socialism" in one letter, and in another, it objected to this passage:

> *Investors don't have passionate feelings of romance* about nuclear fusion these days—in their perpetually flirtatious way they are entranced with the glamor of new names such as the tunnel diode which for them has become the equivalent of the tunnel of love—but it serves to point up the conclusion that the advance of science tends to find more uses for all the world's resources, and therefore the long-term future of copper is good. [Emphasis in original.]

In June and August 1962, the exchange staff for the first time instituted a regular program of spot checking the trading of market letter writers, partners or firms against the market letters issued by the firms, and 71 firms were checked in those months. Exchange representatives have testified that the program will be continued. On November 16, 1962, the exchange issued an educational circular which reported disciplinary action by the board of governors against the managing partner of a member firm for permitting partners, employees, members of their families and discretionary accounts handled by a registered representative to trade against the recommendations of its market letter, which had a substantial public following.[299] Such trading, according to the circular, constituted conduct inconsistent with just and equitable principles of trade:

> The ethical considerations are most important among firm personnel who participate in making the recommendation or have any prepublication knowledge of it. Such personnel clearly should refrain from any action in contemplation of the report, such as making a transaction for their own account, or for accounts in which they have an interest or discretion, or passing on advance information concerning the report to persons outside their firm. Otherwise, such persons might be subject to the suspicion that the purpose of the recommendation was to permit firm personnel and favored customers to profit by activity or price movement which might, or might be expected to, follow such a recommendation.[300]

On February 1, 1963, the exchange announced the initiation of a series of monthly conferences between its staff and member firm executives responsible for advertising, market letters, and sales literature aimed, according to President Funston, at providing "a better understanding of the exchange's rules and standards for advertising and market letters."

[298] The statement was made in a standard hedge clause in material dated June 28, 1962, and the NYSE comment was made on July 27, 1962. For a discussion of the general use of similar statements in hedge clauses, see sec. 4(a), above.

[299] M. F. Educational Circular No. 170; for details of the trading activity, see sec. 7 above. For further discussion of this disciplinary action, see ch. XII.

[300] Id., p. 1.

The exchange market letter and sales literature review program falls considerably short of vigorous and aggressive self-regulation. Its administration raises serious problems which are discussed in further detail in chapter XII. What the program fails to police at all, however, may be more significant than what it does. The exchange actively encourages its members to advertise the quality of their research services,[301] but makes no effort to determine whether the research facilities of any firm are commensurate with its claims. The unwillingness of the exchange to assume responsibility for member firms' research activities is highlighted in the testimony of Ruddick C. Lawrence, exchange vice president in charge of public relations and market development, concerning advertising materials and displays emphasizing research services which the exchange makes available to all member firms:

Question. * * * [H]ow do you know whether the firm is qualified to do research, whether it has a research department capable of handling customers' needs and requirements?

Answer. We don't.

Question. To your knowledge, is any check made of such facilities?

Answer. No.

Question. Is it possible that some firms have no research departments?

Answer. Yes.

Question. Are there such firms, without research departments?

Answer. I am sure there are. They have access, of course, to other research and informational services.

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Question. But the exchange has no knowledge or makes no attempt to determine what the research facilities and qualifications are of a particular firm. Am I correct in stating that is your testimony?

Answer. So far as I know.

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Question. One of the displays states, and I quote:

"As members of the New York Stock Exchange, we offer you these services:

"1. Buying and selling stocks and bonds.

"2. Portfolio planning.

"3. Safekeeping of securities.

"4. Information and advice based on research."

My question is: How can the exchange distribute this display to all firms if it has no specific knowledge of the research facilities and qualifications of member firms?

Answer. The firm ordering the material, of course, has intimate knowledge of its research facilities and its services, and would be expected to use its judgment.

Question. Well, how is the exchange meeting its regulatory responsibilities in this area?

Answer. This is not a regulatory responsibility.

(3) *The NASD*

Like the New York Stock Exchange, the NASD treats the investment advice published by its members as selling literature, and exercises certain restraints on its content. Unlike its control of the selling literature of mutual funds and their distributors,[302] where the NASD enforces the provisions of a long and detailed statement of policy, the NASD approach to broker-dealer published advice has been through a very broad and general rule interpretation which states:

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[301] See pt. B, above.

[302] In 1955 the Commission urged the NASD to adopt a statement of policy governing advertising and other literature used by members comparable to the statement of policy governing investment company shares. The NASD rejected the statement of policy approach in favor of the general interpretation discussed in the text.

It shall be deemed conduct inconsistent with just and equitable principles of trade and in violation of section 1 of article III of the Rules of Fair Practice for a member in any form of advertising (including radio and television), circular, form letter, market letter, or other sales promotional material, to employ "come-on" techniques or to make any statements which are flamboyant, misleading or tend to mislead in the light of the context and purpose of the material presented.[303]

The explanation accompanying the interpretation notes that the Board of Governors encourages the use "of advertising and sales literature to interest and inform the public as to matters pertinent to securities and to investment services and facilities," but adds that "exaggerated or sensational statements or claims" are prohibited. It further states:

Informative sales literature must provide a fair basis for evaluating the facts presented in regard to any particular security or securities or type of security or industry discussed. No material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the advertising or sales literature to be misleading.[304]

NASD members are required to maintain a separate file of all advertising and sales literature for a period of 2 years from the date of use in a readily accessible place.[305]

The nature of the broker-dealer selling literature examined by the study does not suggest that the NASD rule interpretation has had a significant impact on the industry. To some extent this may be due to the broad, general nature of the rule, and to some extent it reflects largely ineffective enforcement. Since, as more fully described in chapter XII, the NASD has no effective national administrative controls, one must look to the district examination procedures to see the practical applications of NASD surveillance of selling literature. The New York district staff officials conceded the limitations of the association's treatment of this matter:

Question. Can you tell us briefly now what is expected on an examination with regard to checking compliance with the association's rules and interpretations regarding advertising and sales literature?

Answer. I am afraid you have hit on one of those areas that doesn't come quite alive to the average examiner. Well, it is required, as you can see by the form, that there be a check of sorts made on the advertising and the sales literature. * * *

Probably the most extensive check of the sales literature, other than mutual fund setup, comes about in those areas where you have examination during the course of which the examiner attempts to demonstrate the boilershop relationship again, or you have a section 2 suitability case in which the sales literature plays a vital and important part in the basic charge.

There you have fairly extensive checks, either by the examiner or the supervisor, of the material gleaned by the examiner. Other than that I am afraid the examiner check on the advertising sales literature is pretty much an establishment of the fact that they keep a file, the type of advertising, and possibly extensiveness of it, with spot checks on content. * * *

The NASD makes little, if any, effort to evaluate the materials which it inspects in light of its "interpretation." Nor is there any general effort to determine whether published market letters may involve conflicts of interest, such as trading against advice. How-

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[303] NASD Manual G–19.

[304] Ibid. As of this writing of the Report, the NASD was considering an extensive revision of this interpretation, which would convert it into a rule and expand its coverage. This proposed rule would require that advisory material be dated and would deal speifically with such matters as reference to past recommendations, testimonials, and purportedly "free" services.

[305] NASD Manual, G–20. They are also, of course, subject to the Commission preservation requirements of rule 17a–4(b)(4) of the Exchange Act.

ever, an experienced examiner who felt that a long position or option position might involve touting in any number of ways, including through selling literature, would be expected to go deep enough in his investigation to develop the basic facts. Generally an examiner would be expected to note whether a firm publishing a market letter employs personnel who do research work, but no particular restraints exist which would require that personnel be adequate to perform the research services it purports to perform.[306]

There have been a few NASD formal disciplinary proceedings involving violations of the interpretation. The cases have dealt largely with sales materials containing the crudest kind of "come-on" techniques, and statements such as "stock is available in limited quantities," "limited time only," "unlimited capital gains," "extraordinary profit possibilities," and "there will be some publicity about the company some time in August that will just send the stock skyrocketing." In the 15 cases in which violations were alleged in the years 1959 through 1961, charges were sustained in 11 cases. It might be noted that no decisions involving the interpretation were found in the three largest association districts.

b. Controls over registered investment adviser conduct

Since few investment advisory firms, whether engaged primarily in publishing advisory services or in investment counseling, are also engaged in the sale of securities, neither their activities nor the content of their materials are subject to the self-regulatory restraints of the NASD or the exchanges. Neither are they members of any other governmentally sanctioned self-regulatory body. Such control over their activities as exists, therefore, springs primarily from the Federal Government.

As with broker-dealers, Federal control over the activities of investment advisers is founded on the concept of fraud, expanded as it is beyond the limited common law concept by the Federal securities laws. Section 206 of the Investment Advisers Act makes unlawful the employment of any device, scheme, or artifice to defraud, or engaging in any transaction, practice, or course of business which operates as a fraud or deceit. It also makes unlawful any use of the mails or an instrumentality of interstate commerce to engage in any act, practice or course of business which is fraudulent, deceptive or manipulative, and the Commission is empowered to enjoin such acts, practices and courses of business as are fraudulent, deceptive or manipulative.[307] The Commission has used its power under this section to promulgate rule 206(4)-1, which spells out in detail advertising practices of investment advisers deemed improper.[308]

In the view of the Commission, the fraud provisions of section 206, standing alone, are sufficient to prohibit the practice of trading against

[306] In a case decided in late 1962, the New York district business conduct committee expelled a member, Robert Martin & Co., Inc. (unconnected with Robert A. Martin Associates, Inc., discussed in ch. II.B.1.a.(3), above) for multiple violations reflecting a boiler-room-type operation. Among the findings were that although the firm advertised its "complete, efficient, active, and experienced statistical department," it did not subscribe to the over-the-counter price quotation sheets, or have either the standard statistical manuals or "any of the other ordinary accoutrements of an organized research department." *District No. 12 Business Conduct Committee* v. *Robert Martin & Co., Inc.*, Nov. 8, 1962.

[307] Investment Advisers Act, sec. 209(e).

[308] The Commission has also promulgated rule 206(4)-2 relating to the custody or possession of funds or securities of clients.

investment advice by registered advisers. Its position has been made clear in the case of *S.E.C.* v. *Capital Gains Research Bureau, Inc.*,[309] in which the Commission attempted to enjoin such activity by one publisher. One of the publisher's two regular subscription services, which regularly recommended purchases of securities, had a paid circulation of 5,000 and in addition was distributed free on some occasions to as many as 100,000 nonsubscribers. During a 9-month period in 1960 the publisher traded in the securities which it recommended, purchasing shortly before the recommendation and selling at a profit shortly after the publication of the recommendation, without disclosing the facts to its subscribers. It also engaged in short sales prior to publishing its recommendations. In one instance, the publication compared two companies in the same industry. As to one where the publisher had a short position, it suggested the stock had reached its peak, while in the other, where it held call options, it recommended purchase. The Commission's action was based upon the theory that these practices, undisclosed, in and of themselves constituted a fraud or deceit. As this report is written, the case is pending in the U.S. Supreme Court.[310]

Rule 206(4)-1, referred to above, which became effective January 1, 1962, expressly prohibits as deceptive the use of testimonials, and imposes stringent controls upon references to past performances[311] and offers of free services. It also makes it deceptive to represent in advertisements that any graph, chart, formula or other device can, in and of itself, be used to determine which securities to buy or when to buy them, or to distribute advertisements which contain untrue statements of material facts or are otherwise false or misleading.

In 1962, the Commission instituted a program to enforce the provisions of this rule. Systematic surveillance is maintained of the leading publications carrying advertisements of registered advisers. Violations of the rule are the subject of letters to the firms involved, conferences with their officials, or formal proceedings, depending on the seriousness of the offense.

During 1962, the Commission instituted two formal proceedings to revoke the registration of investment advisers for circulating material in violation of rule 206(4)—1. *In the matter of Carroll Tillman*,[312] the Commission on June 19, 1962, ordered the commencement of a proceeding based in part on charges that advertising material created " 'false and misleading' impressions in the minds of subscribers that the purchase of securities recommended * * * would result in profit to investors" and represented "through exaggerated, misleading and flamboyant statements that the method of evaluating securities * * * would result in profits to subscribers (while omitting adequately to disclose the difficulties and limitations inherent in such method) * * *." *In the Matter of Anne Caseley Robin d/b/a The Profitmaker*,[313] the

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[309] 300 F. 2d 745, 306 F. 2d 606 (en banc) (2d Cir. 1962), cert. granted, 31 U.S.L. Week 3233 (Jan. 21, 1963).

[310] Ibid.

[311] An industry critic of the rule describes the provisions relating to past performance as "almost prohibitive" and as having the unwanted effect of prohibiting "an interested person from gaining any insight into the past of the investment service under consideration." He urges modification of the regulation to permit reference to past recommendations "presented so as to reasonably reflect both the gains and losses that any individual client might have sustained." Such a rule would present formidable enforcement problems.

[312] Investment Advisers Act release No. 128 (June 20, 1962).

[313] Investment Advisers Act release No. 127 (June 12, 1962).