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## SUPERVISION

### Members Failure to Supervise Is Costly

The need for members to stay alert as to the activities of their registered representatives has seldom been better illustrated than in a recent case which came before a District Committee and the Board of Governors.

In this case there was no dispute over the facts that the salesman had converted and misappropriated customers' funds and securities to his own use and that most of these transactions did not appear upon the books and records of his employer. Further, the salesman over a period of years had accounts both in cash and on margin with other securities dealers and regularly made collateral loans with a number of banks.

When the illegal activities of the representative came to light, several of his customers filed damage suits for alleged losses due to the salesman's conversions and fraudulent acts.

In the complaint filed by the District Committee against the member alleging failure to supervise, the member denied guilt on the ground that it was only with the benefit of hindsight that it could be accused of failure to discharge the salesman. The firm stated that it had no reason to believe the salesman was dishonest, and that some of the things that appeared in retrospect to show laxity or loose controls actually did not stand out in such sharp focus when encountered in the daily routine of doing business.

The record developed at the hearing, however, showed instances

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## BOARD ADOPTS NEW FREE-RIDING POLICY

### 26 MORE NEW ISSUES UNDER STUDY

Twenty-six additional "hot issues" have been named for investigation under the Free-Riding and Withholding Interpretation by the Executive Committee of the Board of Governors.

Questionnaires requesting information concerning the distribution of the following offerings have been sent to underwriters and selling group members: Anthony Pools, Inc.; Bartell Broadcasting Corporation; Barton's Candy Corp.; Biochemical Procedures, Inc.; Bourns, Inc.; Bowmar Instrument Corporation; Dashew Business Machines, Inc.; Digitronics Corporation; Dutton Corporation; Dynex, Inc.; Enflo Corporation.

Also, Genge Industries, Inc.; Gertsch Products, Inc.; Gulton Industries, Inc.; Hydromatics, Inc.; Indiana Gear Works, Inc.; Lindberg Steel Treating Co., Inc.; Missile Systems Corp.; Nova-Tech, Inc.; Oil Recovery Corporation; Perfect Photo Corporation; Photo-Marker Corp.; Radio City Products Co., Inc.; Roto American Corporation; Transitron Electronic Corporation; and Universal Container Corporation.

## BOILER SHOPS

On the recommendation of its new Trading Committee, the Board of Governors urges all members to keep a sharp eye out for operations by so-called boiler shops and to report any information on high pressure sales activities to the Association's Executive Office in Washington.

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### HITS SALES TO STREET MARKET, BANK BUYERS

The Board of Governors has adopted a revised interpretation with respect to free-riding and withholding in connection with so-called "hot issues" distributed by Association members.

The revised interpretation, which is effective April 1, 1960, is designed to clarify and simplify the language of previous statements, as well as to deal with newly developing abuses. Of principal significance is language having these new applications:

1—Sales of new issues by underwriting or selling group members to broker/dealers outside the group are prohibited, except under certain conditions to accommodate customers of the latter. This would stop the current practice in some recent "hot issues" of selling shares to street trading houses that either position the securities for later resale, at much higher prices, or take them for resale to insiders.

2—Sales to personnel in the securities buying departments of banks and other institutions are prohibited, except when there is demonstrable history of bona fide buying for investment as a normal investment practice. All previous reference in this connection to Section 10 of the Rules of Fair Practice is eliminated and the revised interpretation is based wholly on Section 1 of Article III of the Rules.

Text of the revised interpretation follows:

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## Free-Riding

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### INTERPRETATION WITH RESPECT TO FREE-RIDING AND WITHHOLDING

(Reference: Article III, Section 1 of the Rules of Fair Practice)

Article III, Section 1 of the Rules of Fair Practice states that:

"A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

In accordance with Article VII, Section 3(a) of the By-Laws, the following interpretation under Article III, Section 1 of the Rules of Fair Practice is adopted by the Board of Governors and will be applicable to all transactions which are effected after the date hereof.

Members have an obligation to make a bona fide public offering, at the public offering price, of securities acquired by a participation in any distribution, whether acquired as an underwriter, a selling group member, or from a member participating in the distribution as an underwriter or selling group member. The failure to make a bona fide public offering when there is a great demand for an issue can be a factor in artificially raising the price. Not only is such failure in contravention of ethical practices, but it impairs public confidence in the fairness of the securities business.

A member is in a position of trust, when it has information with respect to a particular security, the indicated demand, and other factors bearing on its future price not generally known to the public. To take unfair advantage of such a position as a participant in an offering indicates a lack of commercial honor.

Except as provided herein, if a member either has unfilled orders from the public for a security or has failed to make a bona fide public offering of the securities acquired as described above, it would be a violation of Article III, Section 1 of the Rules of Fair Practice for a member directly or indirectly to:

(1) Withhold any of the securities in the member's account;

(2) Sell any of the securities to any officer, director, partner, employee or agent of the member or of any other member or to a member of the immediate family\* of any such person;

(3) Sell any of the securities to any account in which any person specified under (1) or (2) has a beneficial interest;

A member may withhold for its own account, or sell to persons in categories (2) and (3) above, part of its participation in an offering acquired as described above if the member is prepared to demonstrate that the securities were withheld for bona fide investment in accordance with the member's normal investment practice,\*\* or were sold to such other persons in accordance with their normal investment practice with the member, and that the aggregate of the securities so withheld and sold is insubstantial and not disproportionate in amount as compared to sales to members of the public.

(4) Sell any of the securities to any person in the securities department of, or whose activities involve or are related to the function of buying or selling securities for, banks, insurance companies or any other institutional type accounts, or to a member of the immediate family of such persons;

A member may sell part of the securities acquired as described above to persons in category (4) if the member is prepared to demonstrate that the sales made to such persons are for bona fide investment, are in accordance with their normal investment practice with the member and that the aggregate sales to such persons are insubstantial and not disproportionate in amount as compared to sales to other members of the public.

(5) Sell any of the securities, at or above the public offering

price, to any other broker or dealer;

A member may sell part of the securities to another member if the latter represents to the selling member and is prepared to demonstrate that such purchase was made to fill orders, as an accommodation and without compensation, for bona fide public customers at the public offering price. If such accommodation order is filled for any person in categories (2), (3) or (4) above, the member who fills the order for such person must represent to the selling member and be prepared to demonstrate that such sale was for bona fide investment and in accordance with the normal investment practice of such person with the member.

### DEFINITIONS

#### 1. "Distribution"

The term "distribution" includes all distributions of securities whether registered, unregistered or exempt from registration under the Securities Act of 1933, or whether primary or secondary distributions, including intrastate offerings and Regulation "A" issues. This interpretation does not apply to exempted securities as defined in Section 3(a)(12) of the Securities Exchange Act of 1934.

#### \*2. "Immediate family"

The term "immediate family" for purposes of this interpretation shall include parents, mother-in-law or father-in-law, husband or wife, children or any relative to whose support the member contributes directly or indirectly.

#### \*\*3. "Normal investment practice"

"Normal investment practice" for the purpose of this interpretation is defined to mean the history of investment in an account with the member. If such history discloses a practice of purchasing mainly "hot issues," such record would not constitute a "normal investment prac-



The Association's Board of Governors discusses new interpretation on free-riding and withholding.

tice" as used in this interpretation. If the account involved is that of the member, such account must be clearly an investment account as distinct from a regular inventory or trading account.

Where possible, the terms in any interpretation should be defined specifically, but it would be unwise and impractical to attempt to define every word in an interpretation which is based upon business ethics. As in the case of any other interpretation issued by the Board, the implementation of his statement on "free-riding and withholding" is one for the District Business Conduct Committees and the Board of Governors. The interpretation will be applied to a given factual situation by individuals in the business who are serving on these Committees or the Board. The penalties imposed

will be based upon the seriousness of the violations; and may include censure, fine, suspension or expulsion.

The Securities and Exchange Commission has made a recent study which disclosed certain practices in connection with the distribution of "hot issues" which may involve violations of the Federal Securities Laws or Rules promulgated under these laws. (Securities Exchange Act Release 6097 (1959)) Members should recognize that these practices no less than those prohibited by this interpretation should be eliminated and that before participation in any distribution, members should become familiar with the Commission study and the laws and rules cited therein to insure compliance with the Federal Securities Laws.

## BANK EMPLOYEES

Officers and employees of banks cannot properly discharge their fiduciary responsibilities as bank employees when they are also engaged in the distribution of securities, the Board of Governors has concluded after reviewing the matter of bank employees in the securities business.

Members' attention is called to Regulation R of the Federal Reserve Board, the policies of the Federal Deposit Insurance Corporation, and Article III, Sections 1 and 9 of the Rules of Fair Practice.

In the future, the Association will refuse to accept as members or registered representatives officers and employees of banks.

## EDITORIAL—Part-Time Salesmen

The National Association of Securities Dealers is fully aware of the problems created by part-time salesmen in the securities business.

The Association's Board of Governors has special committees studying part-time salesmen and part-time dealers and their problems, and these studies do not justify any blanket condemnation of the part-timer as a class of securities salesmen of less than average merit, intelligence or honesty. There are, of course, fringe operators in all phases of the business, and full-time employment is no guaranty that high ethical standards will always be observed.

Increasing numbers of teachers, lawyers and other professional persons with high ethical standards have turned to the sale

of securities in the over-the-counter market as a means of increasing their earnings. Any general bar to part-time employment in the securities business would deprive these individuals of a means of supplementing their earnings.

There is no assurance that the public interest is better protected through the full-time employee.

Poor or improper selling practices by ill-trained or unscrupulous persons will exist in some measure in the securities business, regardless of exchange or NASD membership. It is the constant task of both listed and unlisted markets to govern themselves so that any fringe operators and their registered representatives are promptly and effectively punished.

## Supervision

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where the member had correspondence with the salesman's customers regarding transactions not made through or recorded on the books of the member; delayed payments by the salesman to the member for transactions in customers' accounts; transfers of funds from a customer's account to the salesman's account at the salesman's direction, without authorization from the customer; and many similar irregularities.

The District Committee in its decision stated: "We are at a loss to see how any reasonably efficient securities firm having supervisory officers who are knowledgeable and experienced in the business, could possibly have failed to recognize such a glaring pattern of uncontrolled dealings by one of its representatives as is established here. It should have been obvious that

forthright action was needed, for the man was clearly doing business with the public outside the firm, a fact which is now a matter of record. . ."

This member was found in violation of Article III, Sections 1 and 27 (a) and (b) of the Rules of Fair Practice. The penalties: Censure and a suspension from the Association for six months for the member and its two principal officers. Also, the member and its two principal officers were each assessed part of the costs of the proceedings. The Board of Governors reheard the case on appeal and affirmed the decision and penalties imposed at the District level.

Allegations as to the salesman were not pursued in this complaint because he had been convicted in the courts for fraudulent conversion and is now serving a sentence in a state penitentiary.

## Boiler Shops

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The operations of boiler shops or boiler houses have become an increasing problem in these days of very active public interest in the securities markets. As more and more unwary members of the public have been caught in the toils of these fringe operators, their activities have attracted the attention of members of Congress and the Securities and Exchange Commission. The SEC, at a meeting with the Trading Committee, specifically requested the Association to assist in obtaining information on reported boiler shop activities.

Information supplied to the Executive Office will be forwarded to the SEC for use in the cooperative NASD-SEC drive to stamp out illegitimate operators whose continued existence can only bring discredit to the securities business.

The Board's Trading Committee chairman is Edward H. Ladd, 3rd, of the First Boston Corporation. Other members are John S. French, A. C. Allyn and Company, Incorporated; Gustave L. Levy, Goldman, Sachs & Co.; R. Victor Mosley, Suplee, Yeatman, Mosley Co., Incorporated; and Carl Stolle, G. A. Saxton & Co., Inc.

Function of the Committee is to study problems involving the professional trading aspects of the business, including fictitious quotations.

## OVERSEAS QUOTES

Quotations on some 200 American over-the-counter securities are being transmitted daily to 53 foreign nations by Reuters, the international news agency.

The issues are selected from the National and Eastern Regional lists compiled for publication under the NASD by-line. Coverage includes cities in Europe, South Africa, the Middle East, Asia, Far East and Latin America.