

NASD

news

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SEC DECISIONS CLARIFY NASD RULE

Recent SEC decisions in two cases appealed to the Commission by members have strengthened and clarified the application of Section 2 of the Rules relating to recommendations to customers.

In one case, the member argued, on appeal, that "a broker or dealer is not guilty of any misconduct under the language of the rule in making a recommendation unless facts concerning the customer's financial condition and holdings are already known to the broker-dealer."

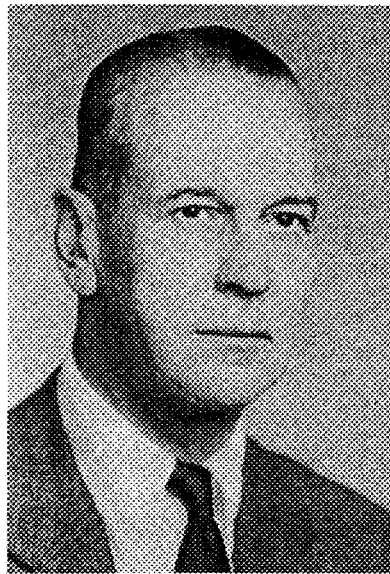
To this, the SEC said: "We disagree. The legislative history of Section 15A of the Act discloses an intent to provide, among other things, machinery to cope with methods of doing business which are unfair to customers and, like other provisions of the rules, Section 2 of Article III was promulgated to achieve this objective. The rule is directed against the making of recommendations to customers under circumstances where there is no reasonable basis for considering the recommendation suitable to the customers, and we do not interpret it as applying solely to situations where information concerning the customer is known to or communicated to the broker or dealer.

"The clear purpose of the rule would be defeated if it were construed as permitting a broker or dealer to engage in a practice of recommending low-price speculative securities to unknown customers—a practice which, by its nature, involves a high probability that the recommendation will not be suitable to at least some of the persons so-

(Continued on Page 2, Col. 1)

NEW QUALIFICATION TEST PLANNED

Start Tougher Exam Before Year-End



Edward H. Ladd 3d, of the First Boston Corporation, New York, is Chairman of the National Business Conduct Committee for 1961. Ted served on the District 12 Committee from 1957 through 1959, the last year as Vice Chairman. His term as Governor expires in 1963.

TAX EXEMPTS

Sales literature concerning investment companies holding tax-exempt securities is subject to the same standards that govern all other sales material in the investment company field.

Thus, all such literature prepared by NASD members is subject to the SEC's Statement of Policy, must be filed with the Association's Investment Companies Department within three days after first use or publication, and may be submitted in advance to that Department for determination as to SOP compliance.

Salesmen seeking to enter the securities business with NASD members soon will face a new and more difficult qualification examination.

The Board of Governors in January approved the employment of The Psychological Corporation of New York City, a leading firm in the field of test development, to assist in the preparation of a new stiffer qualification examination for new people entering the securities business as registered representatives. This action was taken shortly after the Securities and Exchange Commission agreed that the Association could institute a more stringent examination.

Questions and answers in the qualification examination now under preparation will not be available to applicants.

Plans call for furnishing applicants who must pass the examination with a detailed study outline of topics covered in the test before it becomes official. Publication of the booklet containing the questions and answers in the present examination will be discontinued after the new test becomes effective.

Meanwhile, experimental testing of questions under consideration for inclusion in the new examination started April 3rd at 13 of the Association's examination centers located in Los Angeles, Denver, Washington, D. C., Atlanta, Chicago, New Orleans, Boston, Kansas City, New York, Cleveland, Philadelphia, Pittsburgh and Dallas. Applicants reporting to any of these centers should be prepared to spend two hours in the examination ses-

(Continued on Page 2 Col. 3)

SEC Decisions

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licit—without any knowledge of or attempt to obtain information concerning the customer's other security holdings, his financial situation and his needs so as to be in a position to judge the suitability of the recommendation. In our opinion the rule is broad enough to reach such a situation, and we affirm the NASD's findings that it was violated by the firm." (Release #6320)

In the other case, the member challenged almost all of the Association's ethical standards by contending that ". . . the NASD rules requiring a member to have reasonable grounds for believing that its recommendations are suitable for the customer to whom made, to buy or sell to customers at a price which is fair, and to supervise transactions and correspondence of its representatives are invalid under the Sixth Amendment to the Constitution of the United States because they are so vaguely worded that they provide no ascertainable standard of guilt."

The SEC answered this challenge this way: "There is no substance to this contention . . . apart from the fact that the Sixth Amendment, which relates to criminal prosecutions, is not applicable to NASD proceedings, we are of the opinion that the rules in question are sufficiently specific and provide an adequate standard of compliance. . . . Applicant's additional contention that Section 15A of the Act unconstitutionally delegates rule-making powers to the NASD is also without merit . . . a similar contention was specifically rejected by the Court of Appeals for the Second Circuit." (Release #6367)

The SEC upheld the Association's expulsion of the member in both instances.

"SWAP" FUNDS

Share Re-Sale Poses Tax Problem

Dealers and their salesmen will have an increased responsibility for disclosure to their customers should they have occasion to re-sell shares of the new "swap-type" investment companies.

The possibility of a secondary market in these shares—while admittedly remote—causes the SEC considerable concern. The SEC fears that investors who might be willing to purchase shares acquired from an original shareholder of a "swap-fund" may not understand the unusually high potential tax liability they may assume.

To guard against the possibility of less than full disclosures in such transactions, the SEC feels that a word of caution to the securities business is appropriate.

"Swap" or "Centennial - type" funds are one of the newer developments in the investment company field. Their purpose is to permit investors owning individual corporate securities with a low cost and a high current market value to exchange (swap) those securities for shares in a diversified portfolio, without paying a capital gains tax at the time of the exchange. Capital gains taxes must be paid by the original investors, however, when they sell the shares of the "swap fund." And the person buying those shares may be buying a large tax liability also.

When a "swap fund" completes its original exchange of shares for low-cost, high-value securities, it then issues no more shares, but commences to manage the assembled portfolio. Original shareholders normally would be expected to hold their shares as a long-term diversified investment. But some shareholders may well decide at some point to sell. Ordinarily, it would be expected that they would turn in their shares to the fund for redemption at net asset value. If, however, such shareholders offer their shares to other investors

through broker/dealers, the SEC sees need of care in explaining the capital gains tax liability.

Here is why: The "swap fund" portfolio is composed very largely of securities with high unrealized appreciation. For example, one such fund began managing with a portfolio that cost \$13,000,000 and now has a current asset value of \$168,000,000. Having so much appreciation in the portfolio and no new cash from sales, almost any investment decision by the management means the creation of substantial realized securities profits, through sale of portfolio holdings in order to raise cash to buy other securities. These profits, of course, must be paid out to shareholders to maintain the company's freedom from corporate taxes; and the shareholders must in turn pay taxes at their capital gain rates.

The buyer who acquires the shares of an original "swap fund" shareholder, therefore, should be told that he is buying into a situation where most investment moves by management—except sitting tight—mean creating a shareholder tax liability. Under these circumstances, it would appear unlikely that an informed investor would be willing to pay as much as net asset value for such shares.

New Exam

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sion to take both the present examination and the experimental questions.

The new examination, as presently contemplated, will be at least two hours in length, and possibly three hours, in contrast to the present time limit of one hour, and will contain only multiple-choice questions. The present examination contains many true-false questions.

The new examination is expected to be in use well before the year-end.

INSIDER SALES

Recent sales by broker/dealers of stock owned by individuals in a "control" relationship with the issuer apparently have been made without any understanding of legal requirements and the selling firms may well have violated the law in the transactions.

Stockholders in a "control" position or relationship with a company or its officers may be considered within the meaning of "issuers" under Section 2(11) of the 1933 Securities Act and thus be required to register their holdings with the SEC before offering them to the public.

The question of control relationship can only be definitely decided by the SEC. Such control need not be actual control, but can exist where direct stock ownership, the position of director or officer, family relationships or otherwise, puts the selling stockholder in a control relationship with the company.

The normal way of resolving this question is to seek an informal opinion from the Commission and, without a so-called "no-action" letter from the SEC, a broker/dealer selling stock where a control relationship might exist does so at his peril.

STOCK GUIDE

Financial Information Inc. publishes three services widely used by securities dealers in their cashiers', sales, trading, and statistical departments.

The Stock Guide includes information, including details on transfer agents, etc., on over 30,000 companies; Financial Daily Card Service is a watching service on all stock and bond notices; and Financial Daily Called Bond Service is the only daily record of all bond and preferred stock calls.

Descriptive circulars on these services, now 50 years old, may be obtained from Financial Information Inc., 1 Exchange Place, Jersey City 3, N. J.

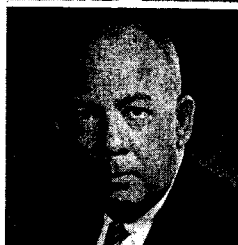
NEW GOVERNORS ELECTED



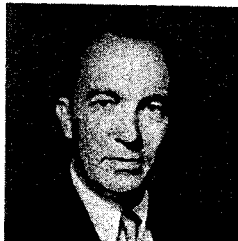
John W. Bunn, of Stifel, Nicolaus & Company, Incorporated, St. Louis, served as Chairman of the District 4 Committee in 1959.



Merrill M. Cohen, of J. M. Dain & Co., Inc., Minneapolis, served on District 8 Committee in 1959-60.



Earl G. Fridley, of Fridley & Frederick, Houston, former Chairman of District 6 Committee.



A. Jackson Goodwin, Jr., of Lee Higginson Corporation, Chicago, was Chairman of District 8 Committee in 1960.



Hudson B. Lemkau, of Morgan Stanley & Co., New York, served on the District 12 Committee in 1958-60.



Robert W. Fleming, of Folger, Nolan, Fleming — W. B. Hibbs & Co., Inc., Washington, D. C., served as District 10 Committee Chairman in 1959 and 1960.



Merl McHenry, of J. Barth & Co., San Francisco, was District 2 Committee Chairman in 1959.

FREE-RIDING

33 "Hot Issues" Under Study

Free-riding questionnaires covering the distribution of 33 recent "hot issues" have been sent to 538 members of the Association. A total of 1563 participations will be examined in this group of questionnaires authorized in January by the Executive Committee of the Board of Governors.

Purpose of the free-riding investigation is to detect cases where members have taken unfair advantage of their position as participants in an offering.

An Interpretation With Respect To "Free-Riding And Withholding" was first adopted by the Board of Governors in 1950 as a counter proposal to the Securities and Exchange Commission which was considering adopting its own rule prohibiting officers, partners and employees of securities firms, or their immediate families, from investing in any new public offering. The intent of the rule was to stop the practice of "free-riding" in so-called "hot issues"—a practice which contributes to artificially raising the price of the issue and impairs public confidence in the fairness of the securities business.

Enforcement of the Interpretation by the Association has made unnecessary any governmental restrictions which would absolutely prohibit persons in the securities business and their families from purchasing a new security issue.

Among the issues now under study are Alarm Device Manufacturing; Allied Maintenance; Astrex, Inc.; Crown Photo; Del Electronics; Forest City Enterprises; Fotochrome; Four Star Television; Fritzi of California Mfg.; Glen Mfg.; Greomar Manufacturing; Klondex; Lence Lanes, Inc.; Nationwide Tabulating; Pacotronics; Park Electrochemical; Resiflex Laboratory; Scantlin Electronics; Sonex, Inc.; Strolee of California; Technical Measurement; Temperature Engineering; Vitramon, Incorporated;

Waterman Products; Yardney Electric; Russ Togs; Pocket Books; and Seaboard Homes.

Members and registered representatives should study the Interpretation to understand their rights which are *protected* by it, as well as to know the acts and practices which are *prohibited* by it.

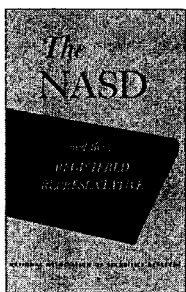
NEW TEXT BOOK

Scheduled for publication by Prentice-Hall, Inc. in May, is a new book, entitled "The Over-the-Counter Securities Markets: A Review Guide," by Leo M. Loll, Jr. and Julian G. Buckley. This is the first book designed to help new people entering the securities business prepare for the NASD qualification examination.

The book contains the "bank" of 441 questions currently found in the Association's "Questions and Answers" booklet. Whenever material in the text relates to a question in the "bank," the number of that question is noted at the end of the sentence.

Registered representatives should find the book valuable in preparing for the NASD test and as a reference book. Price will be \$7.95. Quantity discounts start with the purchase of 5 copies.

NEW BOOKLET



Nearly 50,000 copies of the new booklet, "The NASD and the Registered Representative" have been distributed. This booklet is intended to introduce to new registered representatives the requirements which are particularly important to them, and to serve as a refresher for established personnel. Copies are available from the Executive Office at 15¢ each.

NASD INSURANCE

Plans Open On Non-Medical Basis

Comprehensive major medical insurance and group life insurance is now available to NASD member firms without a medical examination for a limited period.

Over \$6,000,000 of new group life insurance has been written in the first month of this offering.

The trustees of the Association's Insurance Trust emphasize that in addition to the non-medical waiver currently available, the group life premium schedule is now from 15% to 25% below the standard, New York minimum rate for new plans.

There are now more than 8,000 employees enrolled under the group life plan, and 3,000 families are covered under the medical plan.

Maximum individual benefits under the group life insurance plan range from \$20,000 to \$50,000, depending on size of the firm. Dividends of \$1,200,000 have been returned to participating firms since the NASD plan was initiated in 1948, and over \$1,500,000 in benefits were paid to insured persons last year.

The Trustees suggest that NASD members not now participating give serious consideration to these plans, particularly during this temporary period when no medical examination is required.

FAKE BONDS

Members and registered representatives are warned that certain counterfeit coupon debentures, similar to Shell Union Oil Corporation 25-year, 2½% Debentures, due April 1, 1971, in \$1,000 denominations have been discovered.

These fake debentures are lithographic reproductions of the genuine steel engraved debentures. The printing quality is poor; the color of the design underlying the script text on the face is too vivid and too deep; and the imprint of the American Bank Note Co. is missing.