N.A.S.D. NEWS

Published by the National Association of Securities Dealers, Inc.

Volume I | Washington, D. C., March 14, 1941 | Number 7

Lane Opinion Discusses Brokerage Transactions Under Section 22(d)

Explains Application of Provision of Investment Company Act to Execution of Such Orders

Letter Issued at Request of NASD

The SEC recently made public a letter from its General Counsel, Chester T. Lane, to the Association regarding the application of Section 22(d) of the Investment Company Act of 1940 to brokerage transactions in redeemable securities of registered investment companies.

The text of the letter, which is self-explanatory, is as follows:

"Gentlemen:

"You have requested my opinion concerning the application of Section 22(d) of the Investment Company Act of 1940 to a broker-dealer executing a brokerage order for a customer in the redeemable securities of a registered investment company. I assume such securities are being currently offered to the public by or through an underwriter at a price described in the prospectus covering such securities.

"Section 22(d) of the Investment Company Act of 1940 provides in part are follows:

" 'No registered investment company shall sell any redeemable se-

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New Canadian Security Transfer Policy Given

Attention of members is called to the revised policy, effective January 27, 1941, announced by the Canadian Custodian of Enemy Property on January 13, 1941, to be followed in matters relating to the transfer, sale, disposition or redemption of or payment on securities, under the "Regulations Respecting Trading With the Enemy (1939)" of Canada. The letter in which the revised regulations are announced sets forth certain instructions, stating that "compliance in good faith with the following instructions will constitute

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Frank Nominated Judge

Jerome N. Frank, SEC Chairman, has been nominated by President Roosevelt to be a judge of the United States Circuit Court of Appeals in the 2nd District, which embraces New York, Vermont and Connecticut. Mr. Frank has been a member of the Commission since 1937 and Chairman since 1939.

Considerable speculation has arisen as to his successor, both as Commissioner and as Chairman, but no official announcement has as yet been made.

The judgeship to which Mr. Frank was nominated is that vacated by Robert P. Patterson who left that post last year to join the War Department and was later made Under Secretary of War. If confirmed, the Commissioner will be the second SEC member to be appointed to the Bench. In 1939, William O. Douglas, then SEC Chairman, was appointed as Associate Justice of the Supreme Court.

SEC Hypothecation Rules Are Subject of Meetings

Rosenfeld, Green Hold Conferences to Clarify New Regulations—Explanatory Memorandum Issued

Henry L. Rosenfeld, Jr., of Salomon Bros. & Hutzler, New York, N. Y. and Francis T. Greene, Assistant Director of the Trading and Exchange Division of the Securities and Exchange Commission, recently conducted a series of meetings with securities dealers in important financial centers for the purpose of explaining and clarifying SEC rules and regulations.

Mr. Rosenfeld is Chairman of the Technical Committee of the NASD which was formed for the purpose of dealing with all business and regulatory problems affecting the securities business and involving special technical knowledge and treatment. This Committee, for example, worked on, and made recommendations and suggestions to the Association's Board of Governors and the SEC on, such matters as the Commision's over-the-counter rules, the stabilizing rules and program, rules

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Members Approve Proposed Additions to NASD Rules By a Three-to-One Vote

Favor Regulation of Underwriting and Distribution of Securities of Open-End Investment Trusts

Submitted to SEC for Approval

Members have approved the proposed additions to the Rules of Fair Practice of the Association governing certain aspects of the underwriting and distribution of securities of open-end investment trusts by a three-to-one vote. The rule has been submitted to the Securities and Exchange Commission for approval as provided by Section 15A(j) of the Securities Exchange Act of 1934. The effective date of the rule, if approved by the SEC, is June 1, 1941.

Under the By-Laws of the NASD, amendments or additions to its rules, to become effective, must be voted on by a majority of its members and a majority of those voting must approve. The voting was as follows: 62 per cent of the members voted; 46 per cent of the members voted approval; and 16 per cent of the members voted disapproval. However, of those voting, 74 per cent voted approval against only 26 per cent disapproving, making a roughly three-to-one majority of members voting in favor of the rule.

It is generally believed that this addition to the Rules of Fair Practice of the Association will effectively accomplish a real improvement in the business of distributing shares of open-end investment companies, in keeping with the spirit of the recently enacted Investment Company Act of 1940 and the general purposes of the NASD.

Standardization of Procedure

In addition to the benefits to investors from the elimination of certain problems which appeared in the rapidly expanding investment trust business, constructive standardized procedure has been accomplished for underwriters and dealers. The open-end investment company is distinctly an American type of investment trust, the distinguishing characteristic of which is that share-

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Rule Additions Approved

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holders have the right to redeem their shares at approximately asset value.

Assets of these companies have grown in recent years to around $500,000,000 and several hundred thousand shareholders as well as hundreds of investment dealers will be affected by the rule which has been adopted. This action by the NASD represents the first time that cooperative self-regulation has been accomplished in the sale and repurchase of shares of open-end investment companies.

Provisions of Rule

Among the provisions of the rule is one placing the pricing of shares on a twice a day basis, rather than on a once a day basis which has hitherto been the generally accepted practice. This provision is aimed at eliminating as much as possible any "dilution" of equity and also eliminates the so-called "two-price system." The rule limits the "load" or selling commission to an amount which is "not unfair." It establishes a "placement period" in that if new shares issued are redeemed by the company within seven days, both the underwriter and dealer lose their commissions. This is designed to discourage so-called "riskless trading."

Lane Opinion

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curity issued by it to any person except either to or through a principal underwriter for distribution at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus. . . . '

"In my opinion the term 'dealer,' as used in Section 22(d), refers to the capacity in which a broker-dealer is acting in a particular transaction. It follows, therefore, that if a broker-dealer in a particular transaction is acting solely in the capacity of agent for a selling investor, or for both a selling investor and a purchasing investor, the sale may be made at a price other than the current offering price described in the prospectus. Of course disclosure of the fact that the broker-dealer is acting as agent, and of the amount of his commission, must be made to his principal or principals in accordance with the requirements of the Rules and Regulations promulgated by the Commission under Section 15(c)(1) of the Securities Exchange Act of 1934.

"On the other hand, if a broker-dealer is acting for his own account in a transaction and as principal sells a redeemable security to an investor, the public offering price must be maintained, even though the sale is made through another broker who acts as agent for the seller, the investor, or both.

"As Section 22(d) itself states, the offering price is not required to be maintained in the case of sales in which both the buyer and the seller are dealers acting as principals in the transactions."

SEC Held Without Authority to Require Competitive Bidding

Committee Report Finds No Statutory Power for Commission to Promulgate Rule for Utility Securities

View Supported by Legal Opinion

The Securities and Exchange Commission has no statutory authority to promulgate a general rule requiring competitive bidding for utility security issues, according to a report to the Board of Governors by a special committee of the Association. In addition, the report opposes the rule suggested by the Commission's staff requiring such action and opposes in principle competitive bidding for the classes of securities comprehended in the proposed rule.

Accompanying the report, which was filed with the Commission on January 18, 1941, was an opinion by Baker, Hostetler & Patterson of Cleveland, attorneys for the Association, holding that the Commission was without statutory authority to promulgate such rules. The opinion, in addition, said that even if such authority should exist, it would certainly appear to be permissive and not mandatory.

Examined on Merits

In discussing the proposed competitive bidding rule, the report said that whether or not such powers exist does not settle the matter, for if competitive bidding were desirable and the SEC did not have such powers at present, Congress could always grant those powers. Therefore, the Committee decided that this question should also be examined on its merits. The report was prepared by a special committee of the Association, headed by Francis Kernan, Jr., of White, Weld & Co., New York City, and has been approved by the Association's Board of Governors as the basis for further discussion of the subject with the SEC.

"Such a rule would mean radical changes in the present system for the purchase and distribution of securities in respect to a large segment of the capital market of this country," the report said. "Obviously, at such time of emergency in our national affairs, an experiment of this kind is not warranted unless necessary to prevent existing evils. This Committee is unaware of any 'widespread abuses' in the operation of the present system of negotiated transactions in regard to utility securities approved by your Commission under the 1935 Act. The Public Utility Division staff's report notably fails to cite such abuses. The report does infer that no standards exist whereby the Commission can judge the fairness of underwriting spreads. The Commission is furnished with all information as to underwriting compensation paid with respect to all public issues of industrial and utility corporations. To assume that such information does not provide broad and adequate evidence as to standards of underwriting spreads is to pre-suppose that all American business is under the domination of investment bankers. This conclusion seems to us absurd."

Overpricing of Issues

The report noted that the Commission's staff had dismissed possible overpricing of utility issues under competitive bidding as of minor consequence and expressed the opinion that this was against public interest, in contravention of the terms of the Act and in contradiction to the position taken by the Commission in numerous specific cases.

The NASD report expressed a belief that competitive bidding would lead in practice to the virtual dictation of capital issues by the Commission as a substitute for negotiation, because it would lead to standardized forms of financing and indentures, with a sacrifice of the diverse needs of individual companies to a regimented pattern.

"This is a step toward the complete control by government of the private capital market," the report declared. "We are sure that Congress did not intend this, because Congress limited the powers of the Commission in those matters to a supervisory rather than a managerial capacity."

The staff disregarded the consequences of competitive bidding on smaller dealers, according to the report, which said that many of those dealers would be put out of business, seriously crippling facilities for nationwide distribution of securities, and would give large buyers in metropolitan centers a buying monopoly at the expense of investors.

Baird Elected Chairman Of Board; Limbert and Davis Vice Chairmen

Marks Made Treasurer—Fulton Renamed Executive Director—Action Taken on Four Important Matters

National Committees for 1941 Appointed

Robert W. Baird of The Wisconsin Company, Milwaukee, Wis., was elected chairman of the Board of Governors of the National Association of Securities Dealers at the recent meeting of the Board. George W. Davis of Davis, Skaggs & Co., San Francisco, Calif., and Lee M. Limbert of Blyth & Co. Inc., New York, N. Y. were named as Vice Chairmen. Laurence M. Marks of Laurence M. Marks & Co., New York, N. Y. was elected Treasurer. Wallace H. Fulton of Washington, D. C. was re-elected Executive Director of the NASD.

The Board also took action on four important matters: (1) It approved as a basis for further discussion with the SEC, the Arm's-Length Bargaining Committee's report on proposals of the Commission's staff for competitive bidding on utility security issues; (2) It approved the proposed open-end investment company rules recently voted on by the members; (3) It approved a comprehensive uniform trade practice code; and (4) It approved the work of the special Securities Acts Committee.

National Committees Appointed

The national standing committees of the Association, including Executive, Finance, Technical, Quotations, Business Conduct, Uniform Practice, and Investment Trust Underwriters, were recently appointed for 1941. Personnel of these committees is as follows:

Executive: Robert W. Baird of The Wisconsin Company, Milwaukee, Chairman; George W. Davis of Davis, Skaggs & Co., San Francisco; H. H. Dewar of Dewar, Robertson & Pancoast, San Antonio; Lee M. Limbert of Blyth & Co., Inc., New York; John R. Longmire of I. M. Simon & Co., St. Louis; Laurence M. Marks of Laurence M. Marks & Co., New York; Francis F. Patton of A. G. Becker & Co., Chicago; and Wallace H. Fulton of Washington, D. C. (ex officio).

Finance: Laurence M. Marks of Laurence M. Marks & Co., New York, Chairman; Robert W. Baird of The Wisconsin Company, Milwaukee; Hermann F. Clarke of Estabrook & Co., Boston; William A. Fuller of Fuller, Cruttenden & Co., Chicago; and Wallace H. Fulton of Washington, D. C. (ex officio).

Technical Committee

Technical: Henry L. Rosenfeld, Jr., of Salomon Bros. & Hutzler, New York, Chairman; Benjamin J. Buttenwieser of Kuhn, Loeb & Co., New York; James H. Coolidge of McDonald-Coolidge & Co., Cleveland; William A. Fuller of Fuller, Cruttenden & Co., Chicago; and Lee M. Limbert of Blyth & Co., Inc., New York.

Quotations: Frank Weeden of Weeden & Co., San Francisco, Chairman; William Bayne of Arthur Perry & Co., Incorporated, Boston; Edward E. Chase of Maine Securities Company, Portland; Carey S. Hill of Hill, Richards & Co., Los Angeles; E. H. Ladd, 3rd, of the First Boston Corporation, New York; Elwood Miller of E. W. & R. C. Miller & Co., Philadelphia; A. W. Snyder of A. W. Snyder & Company, Houston; Oliver J. Troster of Hoit, Rose & Troster, New York; and Thompson M. Wakely of A. C. Allyn and Company, Chicago.

Business Conduct: Donald C. Bromfield of Garrett-Bromfield & Co., Inc., Denver, Chairman; Edward Brockhaus of Edward Brockhaus & Co., Cincinnati; Arthur S. Burgess of Biddle, Whelen & Co., Philadelphia; Frank Dunne of Dunne & Co., New York; John A. Prescott of Prescott, Wright, Snider Company, Kansas City, Mo.; Harvey Roney of Banks, Huntley & Co., Los Angeles; and Lawrence B. Woodard of Woodard-Elwood & Co., Minneapolis.

Uniform Practice Group

Uniform Practice: Joseph T. Johnson of The Milwaukee Company, Milwaukee, Chairman; Laurence B. Carroll of Prescott, Wright, Snider Company, Kansas City, Mo.; K. F. Deitrick of Blair, Bonner & Company, Chicago; A. L. Godie of Fuller, Cruttenden & Co., Chicago; Robert R. MacGregor of Elworthy & Co., San Francisco; Robert L. Osswalt of Blyth & Co., Inc., New York; William T. Patten, Jr., of Badgley, Frederick, Rogers & Morford, Inc., Seattle; Henry B. Rising of Whiting, Weeks & Stubbs, Inc., Boston; John J. Sullivan of Sullivan & Company, Denver; and Frank Rizzo of 44 Wall Street, New York, Secretary to the Committee.

Investment Trust Underwriters: Henry T. Vance of Massachusetts Distributors, Inc., Boston, Chairman; Robert S. Adler of Selected Investments Company, Chicago; Herbert A. Bradford of Calvin Bullock, New York; John Sherman Myers of Lord, Abbett & Co., Inc., New York; Ivan C. Patterson of The Parker Corporation, Boston; and A. W. Smith of General Investors Corporation, Boston.

709 Registered Advisers

A total of 709 investment advisers had registered with the SEC under the Investment Advisers Act of 1940 as of February 18, 1941, the SEC announced recently. During the period of December 19, 1940, to February 18, 1941, inclusive, 53 applications for registration of investment advisers became effective, the registrations of six investment advisers were withdrawn, and the registration of one investment adviser was cancelled.

SEC Hypothecation Rules

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having to do with keeping and preservation of records and the new rules governing the pledging of customers' securities.

Affect All Firms

Principal emphasis was laid on the explanation of the 8(c) or "hypothecation" rules, which affect all brokers and dealers as well as stock exchange members. In promulgating these rules, the Commission explained that they were designed to put into operation three simple principles laid down in the Securities Exchange Act of 1934 as follows: (1) brokers or dealers must not commingle the securities of different customers as collateral for a loan without the consent of each customer; (2) a broker or dealer must not commingle his customers' securities with his own under the same pledge; and (3) a broker or dealer must not pledge customers' securities for more than his customers owe him.

These rules became effective February 24, 1941.

Memorandum Issued

The NASD and SEC hope, by means of these meetings and discussions with brokers and dealers, to bring about a better understanding of these rules and to assist brokers and dealers in making the necessary changes in present business practices and banking arrangements to effect compliance. Cities visited include Boston, Detroit, Cleveland, Chicago, San Francisco, Los Angeles, Kansas City, Mo., St. Louis, Cincinnati, Pittsburgh, Philadelphia, New York and Baltimore.

As a further aid in this work, The Association recently sent to all of its members a memorandum explaining the provisions of these rules. The memorandum points out that the rules affect practically all brokers and dealers in one way or another even if they do a strictly "cash" business.

Conduct Committee Handling of Typical Complaint Described

Charging of Unfair Prices, Use of Deceptive and Fraudulent Devices in Transactions Charged

Firm Fined $250 for Violations

A District Business Conduct Committee filed a formal complaint against a member firm alleging, on the basis of information supplied by a customer of the firm and a preliminary investigation of exhibits furnished, that in certain transactions the firm did not buy or sell at prices which were fair taking into consideration all relevant factors, that the customer was induced to buy and sell by means of a deceptive and fraudulent device, and that the firm acted as principal in the transactions contrary to written instructions to act as agent.

The member denied the allegations and requested a hearing, which was held. It developed that the firm had unwittingly quoted a price, well over the market price, on certain bonds to its customer and, on receiving an order to sell the bonds, did so at the lower market price, but confirmed the sale to the customer as principal at the quoted price without informing him of the facts. At about the same time, the firm sold to its customer as principal certain stock at a price well over the market price for said stock. The firm explained that although it was well aware that the prices were not correct, it felt that the effect of the discrepancies was negligible as the cash difference between the market prices and the prices charged in both cases was about the same. The firm, subsequent to these transactions, revealed the discrepancy in the prices to its customer and rescinded the transactions, giving its customer cash in place of the bonds which it had been unable to repurchase.

Shift From Agency Basis

In a series of transactions with its customer, the firm had acted as agent, but it had shifted to a principal basis after, it said, the customer had requested confirmations be made to him at a net price. The customer claimed that he was under the impression that the firm had continued to act as agent.

The firm was found to have violated the Rules of Fair Practice in not reporting to its customer the true prices of the securities after it had discovered its original quote was wrong and in charging prices considerably out of line with market prices. These actions were held in violation of Article III, Sections 1, 4 and 18 of the Rules, and the Committee fined the firm $250.

The committee also had other transactions of the firm thoroughly investigated, but decided no further action should be taken after considering a report of this investigation. The committee directed a letter to the firm advising it to become acquainted with the provisions of the laws, rules and regulations relating to the securities business, to revise the various forms used by the firm with customers and other dealers, and to cause the office clerk who performed the function of billing and confirming to become familiar with and understand the different laws, rules and regulations governing such matters in order to obviate errors.

Canadian Transfer Policy

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protection to all persons against any claim which the Custodian might otherwise assert", and further states:

"(a) Transfers, sales or other dispositions of securities are prohibited which, according to the addresses on the books of the company or its transfer agents, or records in their possession, are registered in the names of, or beneficially owned by, persons who are enemies or which appear to be enemy owned as disclosed by any declaration of ownership. Such securities must be reported to the Custodian.

Ownership Declarations

"(b) Transfers, sales or other dispositions of securities registered in the names of persons who, according to the addresses on the books of the company or its transfer agents, are located outside of enemy and proscribed territory and outside of Canada, the United Kingdom and the United States, must be accompanied by a declaration of ownership conforming to Form G.

"Transfers, sale or other dispositions of bearer securities must also be accompanied by Form G.

"PROVIDED HOWEVER that if the registered holders' address on the books of the company or its transfer agents, or the address of the person beneficially interested as disclosed by the declaration of ownership is in *Continental Europe*, the transfer, sale or other disposition must not be effected without the specific approval of the Custodian.

"PROVIDED FURTHER that transfers, sales or other dispositions of securities registered in the name of a bank, broker, investment house, trust company, trustee (in whatever capacity they may be acting), or a nominee, located in the United Kingdom or the United States, must have attached or endorsed thereon, a declaration of ownership conforming to Form G.

Signing of Declarations

"(c) The declaration must be signed by an official of or a signatory for: a Canadian chartered bank; any bank in the United Kingdom; any United States commercial bank or trust company located in New York City or having a New York City correspondent bank or trust company; a Canadian trust company; a transfer agent or registrar for a Canadian security; or a member or member firm of, the Investment Dealers' Association of Canada, The Investment Bankers Association of America, a Canadian stock exchange or Canadian Curb Market, the New York Stock Exchange or the New York Curb Exchange Securities Clearing Corporation; and be signed by or on behalf of the person whose beneficial interest in the security is being transfered, sold or otherwise disposed of."

As described in the instructions, "'ENEMY':—means any resident (regardless of nationality) of the Greater German Reich, Moravia, Bohemia, Slovakia, Poland, Denmark, Norway, Netherlands, Belgium, Luxembourg, Italy and possessions, Albania, Channel Islands, Roumania, French Territory in Europe and contiguous territories of Andorra and Monaco, the French Zone of Morocco, Corsica, Algeria and Tunisia, and all other enemy, enemy occupied or proscribed territory, and any person included in the List of Specified Persons published in the Canada Gazette."

Sample copies of Form G may be obtained from: The office of the Custodian, Department of the Secretary of State, Room 45 S, Central Chambers, Ottawa, Ontario, or the National Association of Securities Dealers, Inc., District No. 13, 44 Wall Street, New York.

District 13 Studies Stock Tax Amendments

District No. 13 of the Association recently appointed a special committee on New York State Stock Transfer Taxes with a view toward suggesting possible amendments to or at least getting some clarifying interpretations of the present Law. The committee will cooperate with other groups interested in the same subject.

The committee is composed of: Oliver J. Troster of Hoit, Rose & Troster, New York, Chairman; Edward J. Costello of The First Boston Corporation, New York; Gustave Levy of Goldman, Sachs & Co., New York; Russell V. Adams of Adams & Mueller, Newark; Eugene L. G. Grabenstatter of O'Brian, Mitchell & Co., Buffalo; and Robert S. Morris of Robert S. Morris & Company, Hartford. George W. Morgan of Breed, Abbott & Morgan, New York, is counsel to the committee.