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MEMORANDUM

September 21, 1961

To: Philip A. Loomis, Jr., Director
Division of Trading and Exchanges

From: New York Regional Office

Re: H. J. Resolution No. 438 (Investigation of Securities Market).
Memorandum of the Chairman of September 8, 1961
to Division Heads and Regional Administrators.

In the Chairman's memorandum of September 8, 1961 in regard to the above matter, he requested the submission of ideas and recommendations as to areas of inquiry with respect to the study. Annexed hereto are memoranda prepared for me by Messrs. William D. Moran, Charles C. Ferrall, Andrew N. Grass, Jr., Ezra Weiss and Federic M. Curran of this office, setting forth their respective views. Rather than attempting to sift and distill these memoranda, I have elected to forward them to you in gross together with this accompanying memorandum of my own on the matter.

I have two general areas of investigation to suggest.

1. The very substantial increase over the last decade in the number of registered customers men and broker-dealers points to a substantial change in the nature of many of the professionals in today's securities market. I suspect - and I believe that an appropriate survey would demonstrate - that many of these new arrivals have little or no experience in or particular competence for the securities business as it has operated in the past. Many of them appear to have a primary interest in turning a

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fast dollar as merchandizers and would feel equally at home in any one of a number of other fields where a premium is placed upon glibness, shrewdness and superficial persuasiveness. In short, I suspect that many of these newer arrivals represent the antithesis of the broker-dealer as an investment counsellor and trusted financial adviser.

I suggest an analysis of all new broker-dealer applications filed over the past few years, coupled with questionnaires to the broker-dealers themselves, exploring their educational and business backgrounds. Next, analysis should be made of the types of new issues dealt in or underwritten by these firms, with a view to determining whether these are primarily of a highly speculative nature. Finally, an examination should be made of the type of sales staff employed by the new arrivals - whether they appear to consist in substantial measure of persons of the same calibre and outlook as the principals, whether they are employed part time or full time, and whether their tenure with any particular firm is a short one or a long one.

2. The next general area that I believe merits investigation is the overall one of marketing techniques with respect to new securities of unseasoned companies. Some of these new issues are regarded - after the fact - as "hot" issues. Others prove more sticky. Some are brought out under Regulation A, others through full registration. In any event, I suspect that a very substantial number of them are marketed through the facilities of firms of the type described in paragraph "1" above. Specifically, information has come to my attention which indicates that the following procedure in many instances has become more the rule than the exception: A small and comparatively inexperienced firm with a number of inexperienced salesmen who have developed a "following" of customers will act as an underwriter or member of the selling group for a series of small and highly speculative issues. Sale of these issues will be limited in large measure to a group of the firm's customers who have been led to understand that they must take up some of each new issue as it comes along, must be


willing to hold it for an indefinite period of time which ends when the broker-dealer indicates that the time is ripe to sell and must be prepared to say "yes" or "no" without any lengthy consideration of the merits of the issuer. To facilitate the full distribution of these issues and to minimize any substantial decrease in the market price, a deliberate effort is made to keep the issue thin from the outset. Issuers are discouraged from offering too many shares. The underwriters are only too happy to see shares of insiders and controlling persons escrowed away from the market. The opportunity for manipulation is maximized.

Under this marketing technique only lip service is given to the philosophy of full disclosure. In most instances the first time a customer sees the prospectus or the offering circular is with his confirmation. As a rule, the customer is under the impression that it is then too late to rescind or refuse to go through with the sale. No emphasis is given to discussing with the customer the merits of the particular issuer as an economic entity. Instead, the emphasis is on the speculative merits of the security as such - whether or not a substantial increase in market price is to be anticipated in the near future. In short, the entire operation has many of the attributes of playing long shots in a horse parlor. One winning horse will make up for the losers.

One way to examine these merchandizing techniques is to take a representative number of broker-dealers of the type described in paragraph "1" above and to analyze - through questionnaires and interviews their operations over a period of about a year. Their customer lists can be scrutinized and a determination made as to how many of these same customers regularly took up each new issue as it came along. These customers could then be interviewed as to their reasons, hopes and expectations in buying, the amount of attention they paid to the prospectus or offering circular, and the extent to which they felt obliged to hold until advised to

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sell and to participate in each offering that came along. The examination might also extend to the motives of these customers in purchasing securities of this type, whether they viewed it as an elegant substitute for the race track (and look to a quick turnover) or as an opportunity to get in on the ground floor of a new potentially flourishing enterprise (and wish to hold for the long run).


LLEWELLYN P. YOUNG
Regional Administrator

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