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Special Market Study
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CHAPTER III

SELLING PRACTICES

In a Report on the study and investigation of "selling practices" in the securities industry conducted by its Special Study of Securities Markets, which was delivered to Congress today by the Securities and Exchange Commission, the Special Study notes "the existing gap between the industry's stated goal of high standards, and the existing conditions in the market place," and calls for positive action by the industry and the regulatory organizations.

In a broad review of the practices involved in the sale of securities other than mutual funds, the Study observes that it gave principal attention to abuses and improper practices, but no "quantitative measurement of the extent of these practices is intended to be reflected." Nevertheless, it concludes, "serious abuses have occurred, and problems exist which unless corrected could cause grave damage to the industry as well as to the public investor." In a discussion of "specialists in speculation," or broker-dealers who concentrate on selling stock of promotional and unseasoned companies, the Study states that "the merchandise they offer and the selling methods they use preclude concern on their part for the interests of their individual customers." The Study also describes boiler-room operations with their characteristic sales by fraud, misrepresentation and material omissions. It notes that "boiler-room practices are clearly not extinct, and while the Commission has made great strides in rapid detection and elimination of boiler-rooms, in most cases the unscrupulous operator has succeeded in dissipating the capital of several victims before the Commission can act."

Among the larger firms, the Study notes, regulatory problems primarily involve inadequate controls and lapses in supervision. These firms, according to the Report, generally attempt to sell securities in an ethical manner. Nevertheless, it states, abuses have occurred which in some cases have rivaled those caused by boiler-room salesmen, and details cases which arose in particular branches of three large firms. It says that "there is no evidence that these practices are typical of how business is conducted by most of the larger firms," but that regardless of their frequency they represent problems "too important to be ignored."

Broker-dealers are charged with responsibility for supervising the activities of their employees, the Report notes, and it reviews the systems which they have instituted to detect certain common abuses, particularly overtrading of customers' accounts, misrepresentations, and recommendations of securities not suitable for their customers. According to the Report, "despite the heavy burden of administrative duties and supervisory responsibilities carried by branch managers, few firms have chosen to relieve them of the burdens of servicing their own customer accounts, and most continue to compensate them for such business on a commission basis." Centralized supervision, the Report states, is "facilitated by, or possible only because of electronic data processing equipment," but it adds that the information produced by the machines must be reviewed by persons with the skill, experience and time necessary to make optimum use of of the data provided. While such controls have been most effective in detecting churning, the Report notes a general absence of fixed procedures to uncover abuses with respect to suitability. It further notes that during the last year "representatives of a significant segment of the brokerage community have exhibited a growing awareness of the importance of adequate supervision."

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The rules and sanctions controlling selling practices which are administered by the Commission, the National Association of Securities Dealers, Inc., the exchanges and the states are also evaluated in the Report. Commission disciplinary proceedings relating to selling practices, it observes, have been primarily directed at situations involving firms engaged in a course of conduct designed to sell securities by illegal means or boiler-room tactics, although they are not exclusively directed at boiler-rooms. Lesser abuses are more often handled by the self-regulatory bodies. The NASD, the Report states, "has in effect a framework of rules which are intended to control the most prevalent objectionable selling practices," and its rule on suitability undoubtedly "has the most far-reaching potential for dealing with improper selling practices," but its methods of detection of such practices are not well developed. The New York Stock Exchange similarly has adequate rules and sanctions, according to the Study, but its methods of detection "have left much to be desired," and it has treated complaints from public customers, often a fruitful source of information on improper conduct of salesmen, "in a manner which at best contributes little to the effective enforcement of its rules."

In its conclusions the Report states, "some segments of the industry appear to be earnestly promoting high standards of selling while others seem only to be earnestly promoting sales." It recommends that the supervision by broker-dealers of the selling activities of their personnel should be strengthened, and suggests the designation of a senior executive in the home office to be responsible for internal supervision and regulatory matters, increasing the branch manager's supervisory role while de-emphasizing his selling activities, and tightening home office control procedures. It also calls on the self-regulatory agencies, particularly the NYSE and the NASD, to "establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision by their member firms." It recommends that the Commission adopt additional rules related to detection of improper selling practices, including requirements that retail transactions be marked "solicited" and "unsolicited," that firms maintain a central file of customer complaints, and that firms record certain basic information regarding customers.

It also states that "Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of suitability of particular securities for particular customers," and urges the adoption of "Statements of Policy" which "can provide the necessary balance between generality and specificity." Noting "the importance of disclosure for the protection of investors," it concludes that officially filed company reports and proxy statements "should have much wider use in selling activities," and that broker-dealers should be obligated actually to consult such data before recommending securities, to furnish copies to customers in appropriate cases, and to advise customers when it is not available.

As to the prevailing industry practices of compensating salesmen in proportion to the volume of business produced in a given month and paying varying rates of commission for different types of securities, the Report concludes "that certain of its particular aspects may tend to introduce undue pressures and biases into the selling process." Among possible measures for consideration by the self-regulatory agencies suggested by the Study to "eliminate or reduce the more extreme forms of pressure or biases in selling" are making monthly compensation less specifically dependent on each month's production, eliminating commission rate step-ups based on production in a given month, discouraging undue compensation differentials for sales of different categories of securities where advisory bias may result from the compensation differential, and requiring disclosure to customers of extra compensation in some situations.

The Report finally notes that the sanctions now available to the Commission in respect of selling practices are sometimes unsuitable to the needs of particular cases, and recommends more flexible powers for the Commission, "so that it may invoke measures appropriate for dealing with particular kinds and degrees of misconduct rather than being limited to the choice between no sanction or an excessive or inappropriate one."

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Research and Investment Advice

As a result of its investigation of the nature of published investment advice distributed to the public by broker-dealers and registered investment advisers, the Special Study concludes that irresponsible dissemination of advice has been responsible for injury to public investors and to the reputation of the investment community and "should receive more positive and effective attention from the self-regulatory agencies." The Special Study also recommends that reckless dissemination of written investment advice "should be expressly prohibited by statute or by rules of the Commission and the self-regulatory agencies and should be made expressly subject to civil liability."

Noting the impressive volume and variety of written investment information originated by broker-dealers, for many of whom its distribution has become an integral part of their businesses, and the lesser but far from insignificant amount of material published by investment advisers who are not engaged in the purchase and sale of securities, the Special Study observes that the materials "raise broad issues of the nature of the responsibilities of their disseminators to those whom they advise." The impact of such advice on the securities markets and the important role of the securities analyst, according to the Report, are "dramatically illustrated" by the history of the Dunn Engineering Corporation, which went into bankruptcy shortly after its enthusiastic recommendation by broker-dealers and subscription publishers. The case demonstrates, the Report states, "the broad gap which can exist between reality and the rosy recommendations of the advisers, and the injury to investors which can result."

In reviewing material distributed by broker-dealers, the Special Study notes that despite differences in emphasis, style, quality and quantity, the material is basically designed to stimulate purchases. Recommendations to sell are for the most part deliberately avoided, according to its Report, and beyond a general classification as to investment goals, little effort is made to evaluate risks for the investor. While the research which the material represents may be "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'," ordinarily little information is given about the extent or method of research, the person responsible for the recommendation, or any interest in or intentions as to the securities recommended on the part of the firm distributing it. Material produced by subscription publishers, the Report indicates, was similar in many respects, particularly in the predominance of recommendations to purchase (although recommendations to sell are not as scarce), and in the lack of information on the subject of the publishers' positions and intentions as to recommended stocks.

Common to material of all kinds, the Report observes, is the suggestion, express or implied, that the recommendations are the product of research, but a survey of research practices "revealed wide variations in the practices followed and the adequacy of research staffs to perform the functions they were called on to perform." The Study adds that "the occasional circulation by broker-dealers under their own name of material prepared by public relations counsel of the company whose stock is recommended or by advertising firms or others represents an abdication of responsibility."

The Report states that while investors expect the advice they receive to be responsibly prepared and impartial, or that any basis for bias will be disclosed, because of the conflicts of many advisers this is not always what they receive. It notes inconsistent views among broker-dealers on the propriety of recommending securities in which the firm is disposing of its position, and reports evidence among broker-dealer and investment adviser firms of "scalping," or buying of securities about to be recommended in anticipation of the market impact of the recommendation and selling immediately thereafter.

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"The investing public gets only modest protection from existing government and industry controls over the form and content of investment advice," the Study says. It notes that the Commission concentrates on selling literature of boiler-room type broker-dealers, and adds that "the self-regulatory agencies have been slow to accept their responsibilities in the area." Registered investment advisers, it comments, "operate largely in an area which lacks any guiding self-regulatory organization."

The Study concludes that a minimum protection for investors is that "firms should not be permitted to represent that they perform research and advisory services which they are not reasonably equipped to perform," and that the NYSE, "instead of indiscriminately encouraging its members to advertise their research and advisory facilities, should adopt standards governing the representations its members may make in this regard." The NASD, it adds, should provide similarly for its membership. Such agencies, it urges, should also "assume responsibility for eliminating irresponsible and deceptive practices by their member firms," including the establishment of standards and more effective market letter surveillance. The Report also recommends that "Reckless dissemination of written investment advice" be expressly prohibited and made expressly subject to civil liability and, as recommended in Chapter II, that registered investment advisers other than broker-dealers be organized into an official self-regulatory association.

Protection of Customers' Funds and Securities

Noting that the broker-dealer community performs quasi-banking and custodial functions for its customers and in doing so regularly handles assets of "enormous value," the Special Study reports that existing provisions for the protection of those assets are generally satisfactory. In certain respects, however, it recommends improvements.

The Report of the Special Study reviews the "financial" and "bookkeeping" procedures and practices of brokers and notes that they result in the generation of large amounts of "free credit balances" (customers balances subject to immediate withdrawal) and other customers' cash equities that frequently are at the risks of brokers' businesses. Brokers also routinely have custody of large amounts of their customers' securities, either in margin accounts or for safekeeping, and they are frequently pledged with banking institutions or lent to other broker-dealers or investors. The rules designed to safeguard broker solvency and control the identification, pledging and lending of customers' securities are therefore, the Report notes, "fundamental to the health of the securities business," since "substantial unprotected losses," in addition to injuring the investing public, "would cause serious harm to the industry's reputation."

The Report, recognizing the excellent solvency history of brokers and the relatively small amounts of losses suffered by the public from brokers' failures, as well as the technical difficulties and disruption that segregating customers' cash balances might cause, concludes that complete segregation is unnecessary "at this time on the basis of past experience." As "minimum protection," nevertheless, it suggest that brokers be required to maintain liquid reserves in a manner similar to Federal Reserve banks and that they be required to inform their customer regularly of the amounts and status of balances held.

Insofar as customers' securities are concerned, the Report concludes that the best practic required by the self-regulatory agencies (stock exchanges and the NASD) in relation to segregation (identification), pledging and lending are adequate, but that to insure universal observan throughout the industry, especially by brokers not subject to self-regulatory control, the Commission should adopt comparable requirements.

The Report also makes recommendations for minor improvements in the Bankruptcy Act, so that it "correlates adequately" with the provisions for the protection of customers' assets.

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Delivery of Securities

The ability of broker-dealer firms to make prompt delivery of securities to their customers is a matter of concern both to the securities industry and to the public, according to the Report of the Special Study. The Report focuses on "fails to deliver," particularly during periods of heightened market activity, which indicate that present securities handling, clearing and delivery methods may be inadequate to meet any sustained increase in volume.

The term "fails to deliver" has a technical meaning indicating the failure of a broker-dealer firm on the delivery side of a securities transaction with another broker-dealer to deliver a certificate at the agreed settlement date to the opposite side. While the term does not include delayed deliveries of securities to customers, the Report indicates that fails to deliver are an important cause of these delayed deliveries.

The Report discusses the rise in volume of fails to deliver in early 1961. A study by the NASD showed that, among 2,600 or more than half of its members, the volume of fails to deliver rose from $657 million in December 31, 1960 to $1,295,000,000 on March 31, 1961 and $1,491,000,000 on April 28.

The Report indicates that one reason for concern over fails to deliver is the effect which consequent late deliveries of securities to customers may have on public confidence in the securities industry. The Report notes that the industry itself is aware of this problem and that, as recently as August 1962, the NYSE cautioned against late deliveries of securities to customers and warned that it "can impair normal broker-customer relations" among customers who expect prompt delivery. The Report also considers the possible adverse effects which fails to deliver might have upon the financial stability of broker-dealers.

A number of suggestions are made as to possible means of reducing the volume of fails to deliver. The Report states that certain amendments to the rules of the exchanges and the NASD might reduce their volume at any given time. It further recommends, however, that certain more basic changes in securities clearing, handling and delivering methods be considered. Among these are the expansion of over-the-counter clearance facilities, and various means for reducing the volume of physical transfer and delivery of securities by the establishment of centralized securities handling systems and depositories.

The Broker-Dealer as Corporate Director

The role played by broker-dealers as directors of publicly held corporations also is reviewed in the Report of the Special Study. Of 4,964 broker-dealer firms replying to a questionnaire survey made by the Special Study, 476 stated that officers, directors, partners, or employees of the firm were directors of one or more companies whose stock was traded on an exchange, and 995 had representation on the boards of over-the-counter companies. Many broker-dealers told the Special Study that they regard service as directors of companies whose securities they underwrote as a part of their responsibility both to these issuers and to customers who had purchased the securities. They emphasized the value to many public companies with inexperienced managements of having an experienced financial adviser on the board of directors. From the stockholders' point of view, the broker-dealer would ensure that up-to-date information concerning the company was disseminated.

It is pointed out in the Report, however, that some broker-dealers are reluctant to act as directors for any of several reasons, perhaps including the Commission's decision in late 1961 that the anti-fraud provisions of the securities laws had been violated where a partner of a broker-dealer firm effected transactions in a listed security for his wife's account and for discretionary accounts of customers, on the basis of advance knowledge of a reduction in the company's regular dividend, received from an employee of the broker-dealer firm who was a director of the company.

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The Report discusses difficulties that may arise from the availability to a broker-dealer, as director, of information not available to the public. The firm may be making an over-the-counter market, selling to its customers, or recommending to its advisory clients the securities of a company concerning which it has inside information. "Broker-dealer firms have a great variety of views and practices in this area," according to the Report. "Some firms take the position that inside corporate information is available for their benefit and that of their customers; others attempt to maintain a wall of insulation between the individual when serving as director and the same individual in relation to his firm, its trading department, and its retail customers. Other firms avoid or prefer to avoid directorships entirely, because of the conflicts problem or for other reasons."

This part of the Report concludes with a brief discussion of potential conflicts of obligation and interest in the securities industry generally. It refers to the "multifarious possibilities" of such conflict, which "make it difficult, if not dangerous, to generalize as to the problems presented or possible remedies. Their total elimination is out of the question; theoretically, it would involve complete segregation of functions--a remedy often invoked or suggested where conflicts are considered." But segregation as a specific remedy for conflicts in the complex securities business "could not be a simple segregation in any traditional sense but would have to involve fragmentation of the business to a point where (as facetiously pointed out in a recent magazine article) each investor would have his own broker who would not be permitted to act for any other customer or for himself."

The Report states, however, that the conduct of broker-dealers performing potentially conflicting functions may need to be the subject of increased regulatory and self-regulatory concern. In particular, it urges that the self-regulatory agencies (the exchanges and the NASD) and the Commission "should institute more positive, continuing programs for the study of important problems of conflict of interest in the securities business, with a view to speaking out on particular questions in the form of cautionary messages, policy statements, codes of ethics, or rules of fair practice, as circumstances may require."

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