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# MARKET-MAKERS, MANIPULATORS AND SHELL GAMES

HAROLD S. BLOOMENTHAL\*

It should be no news that almost everyone<sup>1</sup> from the President of the United States to the smallest shareholder in a mutual fund prefers rising stock prices. Broker-dealers and corporate officials in particular have such predilections. Broker-dealers do, for the reason, among others, that their business is better during periods of rising prices. Corporate officers do for innumerable reasons including some of the following: (a) stockholders with paper profits are happy shareholders; those with paper losses may be on the telephone or at the annual meeting complaining about management; (b) new financing is relatively easier; (c) a cash offering at higher prices results in less dilution of equity; (d) the company may exchange its shares for properties or in a corporate acquisition at a lesser dilution price; (e) officers may sell their stock or pledge their stock as collateral on a more favorable basis.

With so many persons motivated in the direction of higher prices it is not surprising that less than legal methods of influencing the market price are not uncommon events. While they have no corner on this particular market, broker-dealers and in particular market-makers have a particular interest in higher prices. The securities business is a merchandising business which flourishes with rising prices. Presumably, higher prices usually result from general economic conditions, favorable developments relating to specific companies, increased investor interest in purchasing securities generally and other factors over which no dealer has control. In other instances the direction of prices in particular securities are affected by practices illegal or questionable including the following: (a) a planned series of purchases at rising prices; (b) fictitious quotations in the over-the-counter market; (c) arbitrary quotations established by a dominant market-maker; (d) false or misleading statements concerning an issuer; (e) recommendations by a dealer without an adequate basis; and (f) "merchandising"

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<sup>1</sup> There are exceptional instances in which manipulators are interested in depressing prices. This is likely, for example, when the manipulator is attempting to obtain control of a company. A broker-dealer with a substantial short position in a security may also be motivated in the direction of lower prices. For cases involving attempts to depress the market price of a security, see notes 158, 159 *infra*.

a security by concentrating retail sales efforts on a particular security. The juxtaposition of the terms in the title of this article is deliberate; not because all market-makers are manipulators engaged in a shell game, but because there are sufficient numbers so engaged to give rise to concern about the integrity of the markets in many securities.

If the securities business is a merchandising business, one may ask from where does the merchandise come? In many instances it is selected from among the many available securities on the basis of a disinterested objective analysis of the company's merit and potential. In other instances it is selected because the dealer "merchandising" the security, participated in a prior underwriting of the security. In still other instances because many companies have difficulty in obtaining access to trading markets, the dealer in a position to make a market in a security can obtain some type of special inducement for "merchandising" the particular security. The shell corporation, of which much has been said of late, is often an indirect means of attaining access to a trading market and affords some dealers their merchandise.

On July 7, 1970, the Court of Appeals for the Second Circuit in *Chasins v. Smith, Barney & Co.*,<sup>2</sup> rendered a decision which constituted the first judicial recognition of the inherent conflicts of interest that abound in the area of "merchandising" securities. The reverberations of that decision throughout the securities industry were such that the court on March 2, 1971, withdrew its initial opinion and substituted a modified version which restricts somewhat its holding but leaves intact the basic thrust of the decision.<sup>3</sup> The court's modification appears to be predicated on a representation made as *amicus curiae* by the Securities and Exchange Commission that it has the general problem of the role of the market-maker in retail markets under study and expects at long last to propose a rule in this area. This article is an attempt to examine that role within the broad framework of manipulative practices that interfere with the ideal of a free, competitive securities market.

#### THE OVER-THE-COUNTER MARKET

It is the individual decision of innumerable broker-dealers engaged in the trading of unlisted securities to make a market in individual securities that gives rise to an over-the-counter market. The over-the-counter market consists of approximately 4,500 dealers who

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<sup>2</sup> [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,712 (2d Cir. July 7, 1970), *modified*, CCH FED. SEC. L. REP. ¶ 92,962 (2d Cir. Mar. 2, 1971).

<sup>3</sup> See discussion commencing at 610 *infra*.

are members of the National Association of Securities Dealers (NASD) and approximately 400 non-member dealers. Many dealers are strictly retail dealers, in the sense that they make no primary markets in a security, but merely fill customers' orders by buying or selling for the customer from or to other dealers who make primary markets. Such broker-dealers may act as principals, in which event they buy from or sell to their customer, but rely on purchases or sales, as the case may be, from or to other dealers to complete such transactions. Other dealers are strictly dealers' dealers — that is, they buy and sell securities only from and to other dealers. These dealers are making a primary wholesale market in the particular securities they trade. Still other dealers make primary markets and retail the same securities to their customers.

We know something of the composition in terms of numbers of broker-dealers who make markets as a result of the Special Study group's analysis.<sup>4</sup> The Special Study group reported that in early 1962 there were about 1,100 broker-dealer firms which could be classified as wholesale dealers making markets in securities. The Study found that wholesale over-the-counter activity is concentrated in a relatively small number of firms, mostly located in New York City; twenty-five market-makers (seventeen in New York City) accounting for about 50 percent of the total volume of trade by all wholesalers with other dealers.

The following description of wholesale trading is taken from the *Special Study Report*:

Because there is no central location where public orders can be collected, matched and executed, the wholesale dealer is the key firm in the over-the-counter markets. He "makes the market" by advertising his willingness to buy or sell securities for his own account with the expectation of buying at his bid and selling at his offer. There is a wholesale market in a particular security if a broker-dealer stands ready to buy from and sell to other broker-dealers at his quoted prices in amounts at least equivalent to the security's recognized trading unit. Whereas in most exchange stocks only one specialist makes a market, there may be a score of competing wholesale dealers — but there need not be any — bidding for and offering an over-the-counter security. . . .<sup>5</sup>

The over-the-counter market is linked together by a teletype system, private wires, and the telephone. Although transactions are effectuated

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<sup>4</sup> SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 2, at 550 (1963) [hereinafter SEC SPECIAL STUDY REPORT].

<sup>5</sup> *Id.* 554.

and quotations obtained by such means of communication, it is the *National Daily Quotation Sheets*, popularly known as the pink sheets because of their color, that are the basis for much of this traffic. Published daily (on business days) by a private organization and subscribed to by most over-the-counter dealers, it is available in three sections — Eastern, Midwestern, and Pacific.<sup>6</sup> Subscribing dealers daily place quotations in the sheets for securities in which they trade. Such quotations usually include bid and ask prices, but sometimes they are merely in the form of OW (offer wanted) and BW (bid wanted). Occasionally the dealer indicates the number of shares he is willing to sell or buy, but more often the size of the market is not indicated. While fictitious quotations are prohibited in theory, generally there is no effective way to determine from the sheets the size of the dealer's market. The sheets are often used by dealers inserting quotes who are merely looking for a buyer or seller for one small block of stock, but more often they are employed by dealers making a primary market to inform other dealers of their market. There may be from one to several dealers quoting a market in a particular security on a given day. Subscribing dealers use their daily copy to determine who is making a market in a particular security, to determine the best apparent market in the security, and to compare their market with that of other dealers.

The sheets are not, for the most part, available to the general public although some sophisticated investors, particularly institutional investors, may have access to same. Rather, John Q. Public depends upon quotes received from his broker or what he reads in the newspaper. Newspaper quotations are generally a result of the NASD retail quotation system which supplies a national list, four regional lists and supplemental local lists. The NASD makes available daily to news media for the quoted securities a representative interdealer bid and a representative interdealer ask price — that is, in effect a representative wholesale (interdealer) quotation. In theory, disregarding the dynamic aspect of market prices, a purchaser of a security in the over-the-counter market purchasing on a principal basis could check the price he paid (or is quoted) against the current newspaper quotation and determine the approximate mark-up (or mark-down if he is a seller) realized by the dealer.

We are on the eve of a new system of quotations for the over-the-

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<sup>6</sup> Generally each section will carry quotations for securities primarily traded in the particular geographic area. It is not uncommon, however, for a dealer to subscribe to more than one section.

counter market which should make available to the market some of the benefits of a centralized marketplace. The National Association of Securities Dealers has just made available to subscribing members an automated quotation system. Market-makers will enter their bid and asked quotations into computers which can be queried by retail dealers through their own office facilities receiving for the queried security the market-makers' current bid and asked quotes. The retail dealer will then contact directly the particular firm it chooses in order to arrange the transaction. It is expected that 2,000-3,000 stocks will be entered during start-up, but ultimately 20,000 over-the-counter securities are expected to be handled by the system.<sup>7</sup>

We can illustrate the mechanics of effectuating an order in the over-the-counter market. Customer *A* contacts his broker, ABC Company, and places an order to buy 100 shares of XYZ Corporation common stock. ABC Company only retails securities and acts as its customer's agent. ABC Company may have a direct telephone line to a trader at the Dog Company, a wholesale dealer located in the same city, connecting to Dog Company's automatic call distributor. An automatic call distributor is a telephone switchboard by which the Dog Company trader can contact and be contacted directly by other firms or institutional investors. The ABC Company employee may have first consulted the pink sheets to determine that Dog Company does make a market in the particular security or may have been aware of this fact as a result of prior transactions. In any event, at this point the ABC Company employee receives a quotation from the Dog Company trader and if the order is a market order (or within the price range limits imposed by the customer) verbal confirmations to be followed by written confirmations are exchanged. ABC Company then confirms to its customer that it has purchased, as the customer's agent, 100 shares of XYZ Corporation stock at a specified price and adds on its commission.<sup>8</sup> In some instances Dog Company may not actually make the market but may have direct telephone line communications

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<sup>7</sup> TIME, Feb. 22, 1971, at 87, reports the system on stream with 750 leading brokers as subscribers. According to the article, it was developed at a cost of \$23 million and gives instant readings on TV-like consoles on 2,374 of the most actively traded over-the-counter stocks with another 200 to be added immediately. Eventually as many as 20,000 of the approximately 50,000 over-the-counter stocks may be included, according to the *Time* story. See note 98 *infra*, for further description of the system.

<sup>8</sup> If the dealer chooses to act as principal, the transaction will not be immediately consummated. Rather the market-maker will give the dealer a quote which is firm for a few minutes and the dealer will then contact his customer and use that quote as a basis upon which to add his mark-up to reach the price quoted to the customer. If the price is acceptable to the customer, the dealer calls the market-maker back and confirms the transaction verbally thus completing essentially a riskless transaction.

with its correspondent in another city (perhaps, New York City) which makes such a market and furnishes the inquiring broker with the New York firm's quotations. In such event, the local firm executes the order but the confirmation comes directly from the wholesale dealer who compensates the transmitting correspondent by payment of a small service fee.<sup>9</sup>

#### HOW TRADING DEVELOPS

It will be helpful to explore the circumstances under which securities are initially traded in the over-the-counter market. We may, for purposes of illustration, assume a moderate sized and reasonably well-established close corporation that makes the decision to go public. Under favorable circumstances, *e.g.*, a typical "hot issue" market, it may not have any difficulty in finding a well-established (also a relative term in the light of many recent failures)<sup>10</sup> brokerage house to underwrite the issue on a firm basis. With widespread dealer participation throughout the country, the securities may be distributed among a substantial number of purchasers. The principal underwriter ordinarily feels an obligation to make a market in the security; in any event, it is good business for him to do so as a large number of the firm's customers will have purchased the security and will be looking to the firm to act as a market-maker and thus provide them liquidity. Of course, the underwriting terms may have sweetened his desire to make such a market as the firm may have acquired either options or cheap stock as additional underwriting compensation.<sup>11</sup> Assuming a

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<sup>9</sup> Not to be confused with the practice of interpositioning which involves the deliberate placing of one or more dealers between the dealer executing the order and the market-maker. The usual purpose of such arrangements are to compensate the interpositioned dealer for reciprocal business of another type. The practice of interpositioning results in the customer paying unnecessary charges for the execution and, in some instances, executions at a somewhat higher (if a purchase) price than the best price available. For these reasons, among others, the practice has been held by the Commission to violate sections 10(b) and 15(c)(1) of the Exchange Act. *See* Thomson & McKinnon, SEC Securities Exchange Act Release No. 8310 (May 8, 1968).

<sup>10</sup> These failures led to the adoption of the Securities Investor Protection Corporation Act of 1970, Act of Dec. 30, 1970, Pub. L. No. 91-598, 84 Stat. 1636. The Act establishes the Securities Investor Protection Corporation (SIPC), a federally chartered non-profit membership corporation, which will provide protection for the accounts of customers of brokers and dealers and members of national securities exchanges who get into financial difficulty. All registered broker-dealers and members of national securities exchanges are automatically members of SIPC unless exempt under the Act (the exemptions being very limited). The insurance feature will be funded largely by an assessment based upon member dealers' gross revenues. For a brief description, see SEC Securities Exchange Act Release No. 9064 (Jan. 22, 1971).

<sup>11</sup> The Blue-Sky Laws of several states restrict somewhat the extent to which cheap-stock and options may be issued to underwriters. *See generally* Bloomenthal, *Blue Sky Regulation and The Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969). In addition, such

large number of shareholders, a significant amount of trading may be expected in the security and other dealers with local or other interest in the security may also make a competing market.

If we assume a less well-established company — perhaps, one in the promotional and development stage, the securities may have been offered directly by the company or pursuant to a best efforts underwriting by a relatively small brokerage firm or the securities may have just trickled out over a period of time to members of the public. If there was an original underwriter, it may not have the resources or know-how to make a market in the security or it may now be out of business. The company may have a sufficient number of shareholders to warrant a trading market and may have made sufficient progress to have stimulated interest in its shares. Ideally a trading market should develop for its shares at this particular point; however, it is naive to assume that such a market will ordinarily spring into existence without someone taking the initiative. Assuming progress to the point described above, it may, nonetheless, not be easy to come by a trading market. A trading market assumes one or more dealers prepared to make a market and such dealers often expect to be paid a price for making a market. What that price is may depend upon what the dealer is able to extort and the dealer's own concept of respectability. In any event, it may involve access to the company's shareholder's list; daily advice as to transfers; preferential access to information; membership on the company's board; the company's cooperation in distributing information about the company; a block of cheap stock or access to an available supply of stock or what have you. In fact, most market-makers regard what they are doing as being of some value to the company and may demand one price or another (often willingly paid) — some legal<sup>12</sup> and others illegal or questionable in this legal nether land — in return for making a market in this context. The close relationship that may develop between the company and dealer under these circumstances is illustrated by the not atypical remark of one dealer that “[v]irtually every aspect of the company's operations were discussed with me.”<sup>13</sup> The situation seeps with potential for securities violations.

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indirect compensation is subject to review under procedures established by the National Association of Securities Dealers for its members. See CCH NASD MANUAL ¶ 2151.02 (1970). See also May & Co., SEC Securities Exchange Act Release No. 8975 (Sept. 8, 1970).

<sup>12</sup> Access to inside information if improperly utilized is clearly illegal. See note 123 and accompanying text *infra*. See also note 17 *infra*, as to typical requirements in an underwriting agreement directed to the probability that the principal underwriter will make a secondary market after the initial distribution.

<sup>13</sup> See *Levine v. SEC*, 436 F.2d 88, 90 (2d Cir. 1971).



Let us say some frank things about trading markets. In many instances unlike Topsy they don't just develop. A trading market depends not only upon a significant number of shareholders, but also on sufficient interest in the security. Interest in a security doesn't necessarily just happen; it often happens because of dissemination of information. The more favorable the information, the more interest. The more dealers disseminating the information to their customers, the more interest. Dealers with a large "go-go" clientele can generate more interest than others. None of this justifies the dissemination of false, misleading or otherwise fraudulent material. It does point up the fact that without the right people (dealers) generating, through the dissemination of information, interest in a company, the probability of an active trading market in many companies' securities is a remote one.

On what bases do market-makers make a decision to make a market in a security? There is scant empirical evidence available. The *Special Study* did note that "some wholesale dealers consider it an acceptable business practice to receive allotments of 'hot issues' at the public offering price, cheap stock or options as an inducement to make a trading market for a security."<sup>14</sup> Noting that the NASD had adopted rules pertaining to "hot issues," the study went on to point out that "without official NASD expression of general standards or guidelines in this area, wholesale dealers have been largely free to treat the matter of commencing trading markets on this kind of motivation as being left to their discretion in light of their own business standards."<sup>15</sup> On the other hand, as to integrated firms (those engaging in both wholesale and resale business), the study observed "that the trading activities . . . have become of increasing importance in the wholesale markets. This fact is attributable, in part, to the large number of new issues offered publicly in recent years, in which the managing underwriter has often become the principal market-maker for the issue. . . ."<sup>16</sup> The study went on to point out that many integrated firms having underwritten an issue feel the responsibility to sponsor the trading market so as "to maintain a continuous market in securities in which it has placed its customers."<sup>17</sup>

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<sup>14</sup> SEC SPECIAL STUDY REPORT, pt. 2, at 568.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* 578.

<sup>17</sup> *Id.* 585. Underwriting agreements often include provisions designed to facilitate the making of a secondary market requiring the issuer to deliver to the principal underwriter for a specified period, e.g., five years, all financial statements, all general communications (reports, letters etc.) with shareholders, all documents furnished to the SEC, annual shareholder lists, and advice sheets showing daily transfer of shares.

One way to create a demand for a security and, hence, dealer interest is for a company to attract the attention of some of the 13,000 or more financial analysts. Arranging a presentation to a group of analysts is not feasible for many relatively unseasoned companies except, perhaps, during periods of unusual speculative activity. The Financial Analysts Federation (with a claimed membership of 13,000) will permit a company for a fee of \$500.00 per year to make unlimited use of its membership mailing list. Companies subscribing to this service must furnish a brief description of the literature to be distributed along with the purpose of the mailing and the particular mailing must be approved by the Federation.

There is at least one organization offering its services for a fee in arranging for or expanding secondary markets for issuers.<sup>18</sup> This company writes a prospective client as follows:

With your shares continuing to sell far below true values, we thought you might be interested in taking corrective action. We are specialists in this field, and would welcome an opportunity to serve your company — to the end that higher prices and broader markets be attained . . . [We have] long specialized in developing broad and active markets in the shares of deserving corporations. Through our contacts with more than four hundred broker-dealers from coast to coast, we have been successful in generating substantial interest in our clients' stocks. This has often led to such securities doubling or trebling in price . . . our fees are moderate in terms of the benefits that may be expected.

CONTROLLED AND DOMINATED MARKETS —  
“MERCHANDISING” SECURITIES

The phenomena of the sponsor broker and the limited availability of markets for many securities give rise to markets with a sole or dominant market-maker. The *Special Study* noted that “[f]or many securities in the over-the-counter markets, there may be a limited number of dealers — if any — actively making a market.”<sup>19</sup> The Study alluded to the foregoing fact as “one of the most important facts about over-the-counter markets as a broad category.”<sup>20</sup> In 1960, this author directed attention to some of the legal and economic problems that can

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<sup>18</sup> For discussion of the legality of some of the practices suggested by the excerpt set forth, see notes 116, 147 and accompanying text *infra*. The fact that the shares may, in someone's opinion, be undervalued is no defense to a violation of the anti-manipulation provisions. See Halsey, Stuart & Co., 30 S.E.C. 106, 112 (1949).

<sup>19</sup> SEC SPECIAL STUDY REPORT, pt. 2, at 587.

<sup>20</sup> *Id.*

arise in this context<sup>21</sup> and it is not the purpose of this article to rehash what was said there although, in fact, with one exception,<sup>22</sup> not much that is relevant has occurred since that time. The Commission's staff continues to base its cases in this area on a statistical non-analytical approach: participation by a dealer in a large percentage of the trading transactions in a particular security during a given period of time constitutes control and domination.<sup>23</sup> Failure to disclose control and domination constitutes a violation of the antifraud provisions.<sup>24</sup> One of the principal problems with this approach is that it fails to recognize the widespread extent of control and dominated markets in these terms and gives the staff almost "willy nilly" discretion to select its few targets. In fact, those targets generally involve situations in which the staff has other reasons for wanting to put the broker-dealer out of business, the most persuasive of which is the fact that its retail staff has been actively "merchandising" the security with the aid of irresponsible representations.<sup>25</sup>

One of the evils of a market with a sole and dominant market-maker, as observed by the *Special Study*, is the fact that investors may not realize that the very marketability of his security depends upon a single broker-dealer's willingness (and ability) to continue to make a market in the security.<sup>26</sup> The *Special Study* suggested that "[i]f investors had access to reliable information as to the number and identity of the broker-dealers making independent markets . . . at least the wary investor would be alerted and in a position to protect himself at an earlier point . . . ."<sup>27</sup> The Study also noted that in this type of market, the market-maker is often also actively retailing the security and that "[t]he retail prices of a sole or dominant market-maker are not affected by competition but may be affected by the firm's own activity at the retail level."<sup>28</sup> Some of the premises inherent in this conclusion may be arguable, but it points up the real problem in this area — the "merchandising" of securities tied to a market made in part

21 Bloomenthal, *The Case of the Subtle Motive and the Delicate Art—Control and Domination in Over-The-Counter Securities Markets*, 1960 DUKE L.J. 196.

22 See *Chasins v. Smith, Barney & Co.*, CCH FED. SEC. L. REP. ¶ 92,962 (2d Cir. Mar. 2, 1971), discussed at 610 *infra*.

23 Compare discussion in Bloomenthal, *supra* note 21, at 204, with the cases discussed in note 41 *infra*.

24 See *Sterling Sec. Co.*, 39 S.E.C. 487 (1959), and note 41 *infra*. The Commission's earlier dicta that the over-the-counter specialist by effecting a high percentage of the transactions in the security does not necessarily illegally control and dominate the market has been conveniently disregarded. *Norris & Hirschberg, Inc.*, 21 S.E.C. 865, 874-75 (1946).

25 See cases discussed in note 41 *infra*.

26 SEC SPECIAL STUDY REPORT, pt. 2, at 588.

27 *Id.* 589.

28 *Id.* 588.

(if not, in large part) by the merchandising dealer. The Second Circuit in *Chasins v. Smith, Barney & Co.*,<sup>29</sup> has recently taken judicial cognizance of the inherent conflicts involved in this type of situation.

There are, in fact, several situations involving the "merchandising" of securities all of which, in the author's judgment, pose similar and serious problems requiring special attention. By "merchandising" is meant simply special sales efforts often accompanied by above-average selling commissions for the salesmen. The most apparent example is the typical distribution of securities in a conventional underwriting. Commissions are normally well above those earned in trading markets and the involved dealers normally concentrate their efforts on distributing their allotment. The apparatus for this purpose is well-developed and in most instances relatively efficient. The special protections available in this area involve the registration of the security, the delivery of a prospectus and the slowing down of the process necessitated by the registration procedures.<sup>30</sup> In other instances "merchandising" may involve the distribution of a large block of stock which does not require registration, but which involves special sales effort. The large block may, for example, have been acquired and is now being sold by an institutional investor. The *Special Study* recommended, but the Commission never adopted a rule requiring special (but limited) disclosures in this context.<sup>31</sup>

Another area of "merchandising" and the one with respect to which we are most concerned involves the integrated dealer whose retail sales force is encouraged to make a special effort to dispose of a particular security. The motivation for this "merchandising" may be varied — the dealer may have an assured source of supply, the dealer may own a block of stock or warrants, the dealer may be merely interested in trading profits, the dealer may share the company's interest in an active market at rising prices as the dealer expects to undertake further financing for the company or to arrange acquisitions for the company or the like. Unlike the registration process, there is no

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<sup>29</sup> CCH FED. SEC. L. REP. ¶ 92,962 (2d Cir. Mar. 2, 1971). See discussion of this case commencing at 610 *infra*.

<sup>30</sup> On the distribution of securities, see generally 1 L. LOSS, SECURITIES REGULATION 212-90 (2d ed. 1961, Supp. 1969) [hereinafter Loss]; H. BLOOMENTHAL, SECURITIES LAW ch. 7 (1966).

<sup>31</sup> SEC SPECIAL STUDY REPORT, pt. 1, at 569-70. The *Special Study* recommended requiring that a broker-dealer effecting an unregistered distribution be required to file with the Commission a brief notification as to the amount of securities being offered; offering price and underwriting arrangement; source of the securities and whether stabilizing transactions are to be effected. Included in the definition of a distribution were sales of securities of such size to require payment of compensation exceeding normal compensation for routine transactions in similar securities.

mechanism for slowing down the process and making information available directly to prospective investors. Rather, decisions are likely to be made on the basis of a telephone call which requires immediate execution and in an aura of puffing if not outright fraud. If the stock is sufficiently speculative, the dealer sufficiently disreputable and the number of telephones employed sufficiently large this type of operation may be characterized as a boiler-room. In fact, it is only a question of degree that distinguishes the boiler-shop from many respectable members of the brokerage community. This may account in part for the fact that the Commission has never adopted the rule it proposed relating to so-called boiler-rooms.<sup>32</sup>

The Commission attacks the problems outlined in a variety of ways including the following:

(a) The control and domination approach — alleging a violation of the antifraud provisions because of failure to disclose the dealer's dominant position in the market. The basis for such a case is the typical trading quiz<sup>33</sup> that the staff may run which will establish during a specified period the percentage of interdealer and other transactions handled by the respondent dealer. At some point if the percentage is high enough this becomes control and domination.

(b) A variation of the foregoing approach is to establish that the magnitude of transactions engaged in by the dealer in the particular security amounts to a distribution. If a distribution (even one not requiring registration) is involved, then rule 10b-6 automatically comes into play which makes it a manipulative device for a dealer while engaged in a distribution to purchase or even bid for securities of the same class.<sup>34</sup> If, as is the case with respect to our hypothetical situation, the dealer is making a market in the security, it is obviously purchasing and bidding for the security in violation of the foregoing rule. The proof in this instance is again largely statistical and supplied by a trading quiz — the fact that the dealer has distributed (sold), during a relatively short period of time, a substantial block of securities,

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<sup>32</sup> For a case in which the Commission characterized the activities of the broker-dealer as a boiler-room operation, see *B. Fennekohl & Co.*, 41 S.E.C. 210 (1962). Rule 15c2-6 proposed by the Commission in 1962, SEC Securities Exchange Act Release No. 6885 (Aug. 16, 1962), but not adopted, would have made it unlawful for a broker or dealer to use the telephone to offer or sell certain low-priced equity securities of the type often the subject of boiler-room operations.

<sup>33</sup> For cases setting forth the results of a trading quiz inquiry, see *Sterling Sec. Co.*, 39 S.E.C. 487 (1959); *S.T. Jackson & Co.*, 36 S.E.C. 631 (1950). Presumably, computerized technology permits the Commission to now maintain a better surveillance of unusual movements in market prices. See 36 SEC ANN. REP. 94 (1970).

<sup>34</sup> 17 C.F.R. § 240.10b-6 (1970).

establishes the violation.<sup>35</sup> Again, as in the control and domination situation, it is largely a question of which dealers the staff chooses to make as its target.

(c) A third approach is to establish that the dealer distributed false or misleading statements. This type of case can often be proved, but may require a more thorough investigation and a greater degree of proof than the two situations outlined above.<sup>36</sup> Accordingly, it may be easier in this context to rely on the position that the dealer did not have an adequate basis for making the recommendations in question. In such event the mere fact of recommendation and lack of available information establishes the case.<sup>37</sup>

(d) A fourth approach is to establish a manipulation in classical terms — that is, engaging in a series of transactions at rising prices for the purpose of creating the appearance of activity and unloading shares owned directly (or in fictitious accounts)<sup>38</sup> at the manipulated price.<sup>39</sup> This type of case may be relatively difficult to prove, but some manipulations are so crudely undertaken that the staff has no difficulty in proving these charges.<sup>40</sup>

The following excerpts from two Commission opinions<sup>41</sup> are il-

<sup>35</sup> See J.H. Goddard & Co., SEC Securities Exchange Act Release No. 7618 (June 4, 1965); Bruns, Nordeman & Co., 40 S.E.C. 652 (1961).

<sup>36</sup> *Levine v. SEC*, 436 F.2d 88 (2d Cir. 1971); rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1970).

<sup>37</sup> See cases cited in note 116 *infra*.

<sup>38</sup> For an example of a case involving the use of fictitious names for the issuance of securities, see *SEC v. Globus Int'l. Ltd.*, 320 F. Supp. 158 (S.D.N.Y. 1970), in which 100,000 shares were allegedly issued in the names of 100 fictitious persons including one "Potter Stewart."

<sup>39</sup> See cases cited in note 53 *infra*.

<sup>40</sup> See, e.g., Charles C. Wright, 3 S.E.C. 190 (1938).

<sup>41</sup> The excerpts set forth are respectively from Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965), and from J.H. Goddard & Co., SEC Securities Exchange Act Release No. 7618 (June 4, 1965). The Commission had earlier acknowledged that all market-makers who effect a high percentage of the transactions in a security "to some extent dominates the market in" the security, but, nonetheless, do not necessarily thereby violate the federal securities laws. *Norris & Hirshberg, Inc.*, 21 S.E.C. 865, 874-75 (1946). For a rather unsuccessful attempt to determine how the Commission's staff draws the line in this area, see Bloomenthal, *supra* note 21, at 205-10. In *Norris-Hirshberg*, the Commission talked about the substitution of "a private system of pricing for the collective judgment of buyers and sellers in an open market . . ." 21 S.E.C. at 881. Yet, a dominant market-maker cannot substitute an arbitrary price for long unless he is prepared to accumulate a substantial position in the market or unless he is in a position to generate demand through the use of his retail sales force. It is the latter possibility that, in the author's judgment, is more likely to interfere with the collective judgment of buyers and sellers. See discussion at note 166 and accompanying text *infra*. Interestingly enough, in exchange markets so-called specialists are expected to provide (and are criticized for failing to provide) orderly markets by buying or selling against the general trend of the "collective judgment." See SEC SPECIAL STUDY REPORT, pt. 2, at 96-121. One writer has achieved best-seller status by charging that a specialist should have a license to manipulate. R. NEY, *THE WALL STREET JUNGLE* (1970).

lustrative of control and dominated markets as viewed by the Commission:

[Case No. 1:] Registrant's opening bid for USAMCO stock in the sheets on November 14, 1960 was 3. Thereafter, throughout the remainder of 1960 and the first half of 1961, registrant entered daily quotations in the sheets at generally increasing prices. . . . From November 14, 1960 until the end of 1961, registrant made the principal or sole market in USAMCO stock. Through November 30, 1961, registrant as principal sold 312,449 shares, including 76,098 shares to dealers and purchased 311,117 shares, including 104,291 shares from dealers. As agent for customers, registrant purchased 66,312 shares and sold 83,910 shares. Although other broker-dealers published quotations in the sheets from time to time during the period, the role of such firms was in general not significant. . . . Registrant was both the primary wholesale and retail dealer in USAMCO stock, and the market for that stock was dependent upon registrant's continued sales efforts . . . after the salesmen were instructed in September 1961 to cease soliciting buy orders from customers, the market in the stock collapsed. . . .

[Case No. 2:] During the entire period from December 11, 1961 . . . through December 1962, registrant inserted quotations for the stock in the sheets on all but 11 business days, was the high bidder 86 times, and was equal to the high bidder 96 times. Of the 94 times that the high bid was raised by dealers, registrant raised it 39 times independently of other dealers and 22 times at the same time . . . other dealers did so . . . in the period between December 1961 and April 1963, registrant purchased a total of about 390,000 shares of USLIC stock, and sold 360,000 shares of which 306,000 shares were sold to retail customers. Other firms during the period traded at least 244,000 shares, with very little retail selling . . . [selling] almost all shares purchased from dealers or customers either to registrant or to other dealers who in turn sold them to registrant. Thus registrant was both the primary wholesale purchaser and the primary retail seller of USLIC stock and the market for that stock was dependent upon registrant's continued retail sales effort. . . .

A hopeful development in terms of policing the "merchandising" of securities by market-makers is reflected in the Second Circuit decision in the *Chasins* case. In fact, this decision contains in embryonic form the first realistic approach to the problem and tends to vindicate the wisdom of the Supreme Court in sanctioning private actions generally under the securities laws since the most fruitful development after thirty-eight years of experience in the general area has come from private counsel rather than the professional administrators. Involved were four transactions in which Smith, Barney & Co. sold as principal

for its own account securities of four unrelated companies to Chasins in the over-the-counter market. Smith, Barney had acted as underwriter for the distribution of securities of two of the companies and made a market in all four of the securities. Smith, Barney's representatives had analyzed the plaintiffs' securities portfolio and had recommended the purchase of all four of the securities in question. At no time did the defendant dealer disclose to the plaintiff that it was making a market in the securities involved. Smith, Barney contended (probably correctly) with the amicus support of the National Association of Securities Dealers and Association of Stock Exchange Firms<sup>42</sup> that no court had ever required a market-maker to disclose its market-making role. Further, the defendant contended that in not making such disclosures it had followed the customary practice of the industry.

The court treated the issue as to whether the defendant broker in failing to disclose its market-making role failed to disclose a material fact and thereby violated rule 10b-5. The test of materiality in this context is whether such disclosure "might have influenced Chasins' decision to buy the stock."<sup>43</sup> The court's initial opinion concluded that such knowledge

could well influence a client's decision to buy the securities;<sup>44</sup> disclosure of the fact would indicate the possibility of adverse interests which might be reflected in Smith, Barney's recommendations . . . . If over supplied, it may be to the interest of a market-maker to attempt to unload the securities on his retail clients. Here, Smith, Barney's strong recommendations of the three securities Chasins purchased could have been motivated by its own market position rather than the intrinsic desirability of the securities for Chasins . . . .<sup>45</sup>

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<sup>42</sup> See BNA SECURITIES REGULATION & LAW REPORT, Feb. 11, 1970 at A-6. Nonetheless, the NASD has required since 1964, disclosure in market letters and sales reports of the fact that the dealer making recommendations in such literature usually makes a market in the security if such is the case. CCH NASD MANUAL ¶ 2151 (1970).

<sup>43</sup> CCH FED. SEC. L. REP. ¶ 92,962, at 90,558.

<sup>44</sup> Compare the language of the opinion as originally issued as set forth in the text at this point, with the language as modified in the substituted opinion which reads as follows: "knowledge of the additional fact of market making by Smith, Barney in the three securities recommended could well influence the decision of a client in Chasins' position depending on the broker-dealer's undertaking to analyze and advise whether to follow its recommendation. . . ." *Id.* (emphasis added).

<sup>45</sup> [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,712, at 99,137. Language in the text is as set forth in the withdrawn opinion; the introductory clause being replaced by the language noted in note 44 *supra*, with the balance of the statement being retained. Although not specifically referred to, a market-maker has similar motives when it finds itself in a short position, *i.e.*, it has sold more stock than it has purchased. In such a situation the market-maker has a motive to depress the price of stock and could achieve this purpose by recommending to customers its sale.



Not surprisingly, the court cited in support of its decision the Supreme Court decision in *SEC v. Capital Gains Research Bureau, Inc.*<sup>46</sup> in which the Court found that a defendant registered investment adviser who published a newsletter with stock recommendations violated the fraud provisions of the securities laws in failing to disclose that he had a significant position in the securities being recommended. Elsewhere in determining the appropriate measure of damages the court in *Chasins* referred to the fact that the evil in this context "is that recommendations to clients will be based upon the best interests of the dealer rather than the client."<sup>47</sup>

On petition for rehearing the court denied the petition as well as a request for rehearing en banc. The original panel (Smith, Kaufman and Hays), however, modified its opinion in one respect so as to emphasize that in determining that failure to disclose the recommending dealer's market status could have influenced the purchaser's decision to buy the security it was attaching particular significance to the fact that the broker-dealer had made a written evaluation of the plaintiff's portfolio and made recommendations for further purchases knowing that the client would rely on the recommendations. The court in its modified opinion, stated: "In this situation failure to inform the customer fully of its possible conflict of interest, in that it was a market-maker in the securities which it strongly recommended for purchase by him, was an omission of a material fact. . . ."<sup>48</sup> The court then went on to note that the Commission has under consideration a proposed rule which would cover the general area of appropriate disclosures for various types of market-makers.

Three members (Friendly, Lumbard and Moore) of the full court dissented from the decision denying the request for rehearing en banc. It is apparent from this opinion written by Judge Friendly that if the three had constituted the panel deciding the case that they would have reached a contrary result. Judge Friendly refers to the opinion in the principal case as being "predicated on an essential misconception of the role of the market-maker in over-the-counter transactions. . . ."<sup>49</sup> The Friendly opinion suggests that this role is generally

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<sup>46</sup> 375 U.S. 180 (1963).

<sup>47</sup> [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,712, at 99,138. The court allowed damages based upon the difference between the amount paid and the price at which the securities were sold where the sale took place before plaintiff became aware of defendant's violation of the Exchange Act. A measure of this nature could prove to be an effective deterrent as it in effect makes the broker-dealer an insurer against loss if he fails to make the appropriate disclosure to an "innocent" purchaser.

<sup>48</sup> CCH FED. SEC. L. REP. ¶ 92,962, at 90,558.

<sup>49</sup> *Id.* at 90,561 (dissenting opinion).

a benign one and that the fear a market-maker who buys as well as sells is likely to be interested in palming off a stock is an unreal one. Judge Friendly also takes exception to the retroactive application of what he views as essentially a new principle and expresses the fear that the decision "will encourage many suits by other speculators who have suffered losses."<sup>50</sup>

#### THE CLASSICAL MANIPULATION

Once upon a time a financial adviser advised his client (SP) as follows:

SP should advance continually the market price of its shares from the prolonged, rather static range in the low 30's . . . . Such advance should be implemented by SP or one or more of its officials on its behalf, by purchasing shares of SP on the open market on the ASE. The relatively small floating supply of shares . . . should make a relatively easy job of continually advancing SP's market price and such advance will be assisted substantially (if not taken over in a major way from time to time by the investing public and brokerage fraternity) when it becomes apparent through publicity and market action that SP has entered on an accelerated expansion program . . . . The shares purchased . . . can, of course, be used in negotiating future property acquisitions . . . .<sup>51</sup>

The Court in denying the investment adviser his claimed \$1,000,000 fee suggested that in drafting his plan the financial adviser appeared to model it on what is prohibited by section 9(a)(2) of the Exchange Act.<sup>52</sup> In fact, the adviser had described a classical manipulation of purchasing shares in a series of transactions at rising prices thereby inducing others, in the belief the market is going up, to purchase shares.

The basic manipulative scheme described above sometimes accompanied by prohibited wash transactions and matched orders has been the traditional technique of the manipulator.<sup>53</sup> In the case of over-the-counter securities it is often facilitated by broker-dealers placing arbitrarily determined quotations in the national daily quotation sheets;<sup>54</sup> quotations which often are either fictitious in the sense that

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<sup>50</sup> *Id.* at 90,562.

<sup>51</sup> *Davis v. Pennzoil Co.*, 438 Pa. 194, 204, 264 A.2d 597, 602 (1970).

<sup>52</sup> *Id.* at 206-07, 264 A.2d at 603. While section 9(a)(2), 15 U.S.C. § 781(a)(2) (1964), is limited to listed securities, the court held that the described plan also violated rule 10b-5 which is applicable to both listed and unlisted securities.

<sup>53</sup> See *Thornton v. SEC*, 171 F.2d 702 (2d Cir. 1948); *Wright v. SEC*, 112 F.2d 89 (2d Cir. 1940); *R.J. Koeppe & Co. v. SEC*, 95 F.2d 550 (7th Cir. 1938). See also *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

<sup>54</sup> See, e.g., *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970), *discussed at note 70 and accompanying text infra.*

the dealer will back away from them<sup>55</sup> or will purchase shares at the quoted price only in very limited amounts.<sup>56</sup> In this context the dealer may be constantly reaching for stock at a higher price by deliberately quoting (and paying) more than is necessary to acquire the stock.<sup>57</sup> Dealers may be persuaded to enter bids in the sheets at prices higher than the demand warrants with the knowledge that a particular dealer will repurchase undisposed shares at a guaranteed, slightly higher, price from them.<sup>58</sup> As noted by the Tenth Circuit, this type of activity not only creates an artificial price level but gives the appearance of a broad and active market when in fact there is only one dealer making the market.<sup>59</sup> An SEC rule now requires dealers placing quotations in the sheets for other dealers to indicate that such is the case by an appropriate symbol.<sup>60</sup>

The classical manipulation can be aided and abetted by the dissemination of false rumors, broker-dealer recommendations and "merchandising" and by paid-for recommendations by newspaper publishers or writers. The latter practice commonly known as "touting" a security is specifically unlawful under section 17(b) of the Securities Act.<sup>61</sup> Behind a manipulation of the classical type is usually an obvious motive — the desire of the manipulator to dispose of shares at the manipulated price.

Establishing a classical manipulation usually involves a trading quiz as in the case of the controlled and dominated market with emphasis on the role the alleged manipulator's transactions played in raising the market price of the security.<sup>62</sup> The intention to induce others to purchase is generally established by inference.<sup>63</sup> While such cases are fairly difficult to prove, the Commission in broker-dealer revocation proceedings may not require too much evidence beyond motive. Thus, in one case<sup>64</sup> in which a violation of 9(a)(2) was found, the broker-dealer for the period involved purchased (or was responsible

<sup>55</sup> SEC SPECIAL STUDY REPORT, pt. 2, at 572.

<sup>56</sup> In fact, it is generally assumed that the market-maker need purchase or sell only a so-called trading unit, generally 100 shares, at his quoted price which in the case of a low-price security doesn't represent much of a market. See *Franklin Nat'l Bank v. L.B. Meadows & Co.*, 318 F. Supp. 1339 (S.D.N.Y. 1971).

<sup>57</sup> See, e.g., *SEC v. Pearson*, 426 F.2d 1339 (10th Cir. 1970).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at 1342.

<sup>60</sup> Rule 15c2-7, 17 C.F.R. § 240.15c2-7 (1970).

<sup>61</sup> 15 U.S.C. § 77q(b) (1964). See *United States v. Amick*, 439 F.2d 351 (7th Cir. 1971).

<sup>62</sup> See cases cited in note 53 *supra*.

<sup>63</sup> Thus, the character of the market transactions themselves and the existence of an option in the manipulator were regarded as sufficient to establish motivation in *Charles C. Wright*, 3 S.E.C. 190 (1938), *aff'd sub nom. Wright v. SEC*, 112 F.2d 89 (2d Cir. 1940).

<sup>64</sup> *Mates Fin. Servs.*, SEC Securities Exchange Act Release No. 8836 (Mar. 9, 1970).

as a result of its recommendations for the purchase of) 151,000 shares out of a total of 1,169,000 shares traded or approximately 12½ percent of all shares purchased. While the stock rose during this period involved from 5⅜ to 14, most of the rise occurred on the date of an announcement by the company of admittedly true and material information. The respondent broker had an obvious motive for attempting to increase the price of stock as it had accumulated a substantial inventory in the stock for the portfolio of a Fund it managed at relatively low prices on the basis of material undisclosed information made available to it by an insider.

#### THE SHELL GAME AND VARIATIONS

If you were speculating in uranium stocks during the first uranium boom (circa 1955), you may have purchased shares of the Jolly Jack Uranium Company. Offered pursuant to Regulation A, it appealed to many speculators and was fairly widely held and traded in the over-the-counter securities market. The company never found uranium and probably exhausted its potential for finding uranium; it is in effect a dormant corporate shell. There are in fact a large number of such dormant corporate shells each of which at one time had a substantial number of shareholders and a secondary market for its securities. Some of them were organized long before 1955 and became dormant even at an earlier date.<sup>65</sup> At one time,<sup>66</sup> and perhaps even at the present time, trading continues on one or two of the lesser exchanges in shares of companies listed on that exchange even though the company for all practical purposes is dormant.

The shell game is by no means a new phenomenon; it has been with us for many years. In its traditional form, the players in the game find a dormant company with a large number of shareholders. Through one means or another they obtain control of such a company — possibly, by buying out the former controlling shareholders or by induc-

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<sup>65</sup> In fact, a corporation which had issued stock prior to 1933 has been regarded as particularly attractive to some promoters on the mistaken assumption that the exemption for securities issued prior to the enactment of the Securities Act provided for by section 3(a)(1) of that Act, 15 U.S.C. § 77c(a)(1) (1964), would be available. However, the provision excluding from the exemption new offerings of such securities by an issuer or underwriter precludes reliance on the exemption in the usual shell corporation situation. *See SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970). For an early case involving a shell corporation, see *S.E.C. v. Mono-Kearsage Consol. Mining Co.*, [1959-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 90,894. (D. Utah Oct. 8, 1958).

<sup>66</sup> In the proceeding withdrawing the registration of the San Francisco Mining Exchange as a registered national securities exchange, the Commission noted that of the forty-two stocks listed, twenty-three had no revenues or revenues of less than \$1,000. Some of the activities described involved the typical shell corporation manipulation. San Francisco Mining Exchange, SEC Securities Exchange Act Release No. 7870 (Apr. 22, 1966).

ing the control group to have the corporation issue a large block of stock to them in exchange for properties. Properties in any event are transferred into the dormant shell and rumors commence to circulate with varying degrees of foundation concerning the properties and the promoters' plans. Dealer interest is revived in the company and a trading market comes into being based in part on the former dealer and shareholder interest in the corporation.

The Commission frowns upon the utilization of shell companies and has used its powers to suspend trading in over-the-counter securities as a means of discouraging their use, has proposed some special rules relating to such arrangements,<sup>67</sup> and has taken other steps as we shall see to discourage their use. Yet, some promoters (would-be corporate organizers) including some reasonably respectable ones<sup>68</sup> have been prepared to pay for the purchase of control of such corporations even though the corporation's assets are worthless. The one asset a shell corporation has is a large number of stockholders and, perhaps, several broker-dealers that formerly made a market in the company's securities who might be tempted to do so again (because of the interest of their own customers) if the company were to be revived by a transfusion of properties. Of course, the promoters could acquire a constituency of shareholders by organizing a new corporation and giving away shares to a large number of individuals which is what is being done in effect when a shell corporation is utilized. Watered stock problems aside, this would not accomplish the promoter's purposes as the donee shareholders would not be clustered around particular brokers inclined to make a market in the security.

The promoters utilizing shell corporations may be of the traditional type who have the classical manipulation previously described in mind. In such event the promoters can be expected to bail out as soon as they succeed in raising the price of the stock. The Commission's staff likes to make the assumption (and not wholly without reason) that this is the usual situation. Nonetheless, in other instances, they may be well-intentioned but naive and poorly advised individuals who are willing to pay this sort of price (that is, give away part of the corporation's equity) in order to have access to an instant market in their security. The motivation for seeking such a market rather than fraud

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<sup>67</sup> See discussion at note 94 and accompanying text *infra*.

<sup>68</sup> In the fall of 1969, Gulf and Western Industries, Inc., a well known conglomerate listed on the New York Stock Exchange, spun-off as a dividend to its shareholders shares in a newly organized subsidiary. See BNA SECURITIES REGULATION & LAW REPORT, Aug. 20, 1969, at B-1. See also discussion at note 89 and accompanying text *infra*, for the spin-off variation of the shell corporation.

may be the normal reasons for seeking a secondary market and a recognition of the obstacles to access to such a market through conventional channels. The scope of activity (at least prior to the Commission's hard-line policies) in shell corporations is illustrated by the fact that between July 15, 1969 and October 10, 1969, twenty-five different advertisements offering to purchase shell corporations appeared in the Wall Street Journal. During the same period, nineteen advertisements in the same journal sought to sell shell corporations.<sup>69</sup>

The shell game of the fraudulent variety is vividly described in Judge Medina's Second Circuit opinion in *S.E.C. v. North American Research and Development Corp.*<sup>70</sup> A triumvirate of Canadian promoters sought and found their corporate shell in Utah — a publicly-held inactive company named Utah Fortuna Gold Company, 70 to 80 percent of the stock of which was owned by one shareholder. In due time they had acquired the shares of the controlling shareholders and others as a result of which they owned approximately 96.8 percent of the outstanding stock for which they had paid a relatively nominal cash consideration. They had intended to transfer certain Canadian mining claims to the shell, but upon learning of the availability of an unpatented and untested process for producing pollution-free coke they concluded that such a process would be more appealing to the imagination of prospective over-the-counter investors and arranged to acquire this process for the corporation. Changing the name of the corporation to North American Research and Development Corporation, they then prepared a misleading progress report characterized by the court as "a slick piece of work, but not slick enough."<sup>71</sup> This report was distributed to a large number of securities firms and was followed by personal "touting" visitations to many securities dealers. A Jersey City broker was found who at their instance commenced quoting the stock at the arbitrarily determined quotation of \$21¼ bid, \$2¾ offered; the price ultimately rose to \$6.00. In the meantime the promoters commenced distributing by way of Toronto, shares destined ultimately for the United States. The court had no problem in finding violations of registration<sup>72</sup> and fraud provisions.<sup>73</sup>

The Commission had sounded an early warning in July of 1969

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<sup>69</sup> The cited statistics were taken from a speech given by Hamer Budge, then Chairman of the Securities and Exchange Commission, to the National Security Traders Ass'n, Oct. 19, 1969, reported in *BNA SECURITIES REGULATION & LAW REPORT*, Oct. 22, 1969, at X-5. 70 424 F.2d 63 (2d Cir. 1970).

<sup>70</sup> 424 F.2d 63 (2d Cir. 1970).

<sup>71</sup> *Id.* at 69.

<sup>72</sup> Securities Act of 1933 § 5, 15 U.S.C. § 77e (1964).

<sup>73</sup> Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970).

to the securities industry,<sup>74</sup> noting that market prices of shell corporation shares had risen sharply under circumstances bearing no relationship to the underlying financial condition and business activities of the company. The Commission cautioned broker-dealers to assure themselves that they have sufficient information about the issuer and persons effectuating trades so as to avoid violations of the securities laws. In particular the Commission had in mind the duty of a dealer to avoid the making of recommendations without a reasonable basis and the duty of a broker-dealer to avoid participation in an unlawful secondary distribution. The early warning was followed by a hard-hitting speech of the then Chairman of the Commission, Hamer H. Budge, delivered on October 19, 1969 to the National Security Traders Association. Chairman Budge described the shell game in outspoken terms. He pointed out that it was facilitated by the placing of quotations in the pink sheets and urged traders to recognize the shell situation for what it is and to instigate through his firm an investigation into the affairs of the issuer before engaging in trading. Chairman Budge continued: "You are the professionals and of all the people in the industry, you would be the first to recognize a phony stock or a phony price . . . ." In fact, while not to be attributed to Chairman Budge, manipulation of a shell corporation stock would be difficult to accomplish without the active connivance of a trader-dealer.<sup>75</sup> Chairman Budge observed that "[t]he Commission has already developed and is continuing to develop cases involving nationwide shell distributions by hard-core criminal elements."<sup>76</sup>

The Commission has used effectively its power to suspend trading in over-the-counter securities so as to bring apparent manipulations in shell corporation stocks to an early halt.<sup>77</sup> This power is particularly

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<sup>74</sup> SEC Securities Act Release No. 4982, Securities Exchange Act Release No. 8638 (July 2, 1969).

<sup>75</sup> See, e.g., SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970); SEC v. Les Studs Corp., CCH FED. SEC. L. REP. ¶ 92,866 (S.D.N.Y. Oct. 5, 1970). The Commission has observed that the shell corporation manipulation distribution pattern "generally can only be successfully accomplished through the efforts of brokers and dealers." SEC Securities Exchange Act Release No. 8638 (July 2, 1969).

<sup>76</sup> Reported in BNA SECURITIES REGULATION & LAW REPORT, Oct. 22, 1969, at X-5.

<sup>77</sup> The Commission's authority to suspend trading in over-the-counter securities was added by 1964 amendments to the Exchange Act and is found in section 15(c)(5) of that Act, 15 U.S.C. § 78o(c)(5) (1964). Two days after Chairman Budge's speech, the Commission suspended trading in four companies for the period October 21-30, 1969. Three of the companies involved had previously placed advertisements in the Wall Street Journal as to their availability as shell corporations. BNA SECURITIES REGULATION & LAW REPORT, Oct. 22, 1969, at A-4. On December 12, 1969, the Commission announced the suspension of seven shell firms. SEC Securities Exchange Act Release No. 8783 (Dec. 12, 1969). Such trading suspensions have been followed in some instances with injunctive actions. See, e.g., SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970). See also note 79 and accompanying text *infra*.

effective, if employed sufficiently early, as it can prevent the usual upward price spiral and can effectively squelch unfounded rumors. Typically, before lifting such a suspension the Commission requires the issuer to correct unfounded rumors. The following disclosures of this type by an issuer are illustrative:

The following rumors concerning Santa Fe have been circulating, none of which are true. They are absolutely *false*. We do not have two former governors of Colorado on our board of directors. We are not operating a silver mine. We are not being taken over by an insurance company. We do not have the food and beverage concessions on the ship Queen Elizabeth. We are not contemplating building a ski lodge near Georgetown, Colorado . . . . As of February 1, 1968, the company . . . had current assets consisting of cash in the sum of \$7.80 . . . .<sup>78</sup>

The Commission has moved on many other fronts in its war against the shell game. It has initiated broker-dealer revocation proceedings,<sup>79</sup> sought and obtained injunctions,<sup>80</sup> obtained indictments,<sup>81</sup> proposed a rule and undertaken other initiatives. In one broker-dealer revocation proceeding<sup>82</sup> the Commission charged that the dealer had engaged in a continuing pattern of market-making activities with respect to shell corporations thereby creating the appearance of a fair and bona fide market and trading activities in such securities; that the securities purported to represent the ownership of valuable interests in operating business entities when, in fact, such securities did not represent such value. While this case has not been disposed of, the charges, if sustained as a violation of the securities laws are broad enough to make trading in most shell corporations fraudulent per se.

The shell game in its classical form, as we have noted, is designed to result in artificially inflated stock prices fed by false rumors with the organizers bailing out at the inflated prices. As such, it is likely to involve an unlawful manipulation,<sup>83</sup> fraudulent representations,<sup>84</sup> the

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<sup>78</sup> Santa Fe Int'l, Inc., SEC Securities Exchange Act Release No. 8284 (Mar. 27, 1968).

<sup>79</sup> See, e.g., Stone, Summers & Co., SEC Securities Exchange Act Release No. 8885 (May 15, 1970).

<sup>80</sup> SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970); SEC v. Capitol Holding Corp., SEC Securities Exchange Act Release No. 8730 (Oct. 23, 1969).

<sup>81</sup> In October of 1970, the United States Organized Crime and Racketeering Strike Force in New York City announced indictments in the case of United States v. Tortorello. Indicted were eight defendants and a shell corporation for alleged violations of the registration provisions of the Securities Act. BNA SECURITIES REGULATION & LAW REPORT, Nov. 11, 1970, at A-1. See also note 62 and accompanying text *supra*.

<sup>82</sup> Stone, Summers & Co., SEC Securities Exchange Act Release No. 8885 (May 15, 1970).

<sup>83</sup> See note 53 and accompanying text *supra*.

<sup>84</sup> See discussion at note 36 and accompanying text *supra* and note 118 and accompanying text *infra*.



distribution of securities in violation of the registration provisions,<sup>85</sup> and recommendations by brokers without an adequate basis.<sup>86</sup> In fact, the easiest charge to establish will ordinarily be a violation of the registration provisions and hence Commission action on this basis is most likely. Further, because of its power to administratively revoke or otherwise impose sanctions on dealers, the Commission can be expected to utilize the failure to have a reasonable basis for a recommendation as a basis of attacking the dealer fomented and/or abetted shell game.<sup>87</sup> As we have already seen, to head it off at the outset, the power to suspend trading can be and has been effectively utilized. Although the sine qua non of the typical shell game is to manipulate stock prices, because of the complexity of proving a manipulation, this is likely to be a last resort route by the Commission unless it succeeds in establishing that trading in shell corporations is per se manipulative.

A variation of the shell game is for Company X, a relatively new or relatively inactive company, to sell a block of its shares to Company Y, a publicly-held company.<sup>88</sup> Company Y then spins-off the shares acquired in the X Company to its own shareholders as a dividend and thus Company X now has an instant market in that dealers previously trading in Company Y shares are likely to also make a market in Company X shares. The Commission has cautioned<sup>89</sup> that, despite the notion that a dividend does not ordinarily involve a sale of securities,<sup>90</sup> that it will view the transaction as a sale by the X Company to the Y Company with Y Company being characterized as an underwriter because the

<sup>85</sup> See *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970).

<sup>86</sup> See cases cited in note 117 *infra*.

<sup>87</sup> *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970).

<sup>88</sup> The Commission's complaint seeking an injunction in *SEC v. Harwyn Indus. Corp.*, filed in New York's Southern District Court on June 2, 1970. See *BNA SECURITIES REGULATION & LAW REPORT*, July 1, 1970, at A-3, which outlines a fairly typical spin-off arrangement. A, the owner of all the outstanding stock of XYZ Corporation, desiring to turn the corporation into a publicly-owned corporation, transferred all of his shares in XYZ Corporation to Academic Development Corporation, a wholly-owned subsidiary of Harwyn, in exchange for 800,000 shares of Academic. At the time of the transaction all of the outstanding 1,000,000 shares of Academic were held by Harwyn; after the transaction Harwyn had 200,000 shares of Academic remaining which it distributed as a dividend to its 500 shareholders. Thereafter a trading market developed with respect to Academic shares. Thus A acquired an 80 percent interest in Academic; Harwyn shareholders own 20 percent of Academic; Academic has directly or indirectly whatever assets Harwyn may have put into it originally and the assets acquired from XYZ Corporation; XYZ Corporation is now a wholly-owned subsidiary of Academic, and there is a trading market in Academic stock.

<sup>89</sup> SEC Securities Act Release No. 4982, SEC Securities Exchange Act Release No. 8638 (July 2, 1969).

<sup>90</sup> A stock dividend ordinarily is not a sale as that term is defined by section 2(3) of the Securities Act, 15 U.S.C. § 77b(3) (1964), since it is not a disposition for value. See SEC Securities Act Release No. 929 (July 29, 1936).

overall transaction contemplates an ultimate unregistered distribution to those who purchase the shares in the open market from the Y Company shareholders. The evil in the Commission's view is that a trading market has been created in the shares of the issuer "without the disclosure required by registration." The Commission's theory brings into play the registration provisions of the Securities Act and it has initiated proceedings based on this theory;<sup>91</sup> despite reservations expressed by some,<sup>92</sup> precedents in analogous situations<sup>93</sup> support the Commission's concept of a distribution.

#### PROPOSED RULE 15c2-11

The Commission on June 24, 1970 proposed rule 15c2-11 which would preclude dealers from submitting quotations to an inter-dealer quotation system if the security had not been regularly traded in the over-the-counter market during the previous thirty days unless certain specified current information is available concerning the issuer.<sup>94</sup> While the scope of the rule is sufficiently broad to encompass some companies that might not be characterized as shell companies, it is intended primarily for the purposes of reaching trading in the securities of shells. The Commission in announcing the proposed rule stated that some dealers have made "hasty submission of quotations in the daily sheets . . . in the absence of any information about the security or the issuer . . . . In many cases this practice has resulted in an irresponsible numbers game which, apart from having the effect of foisting unseasoned securities on the investing public, is not only disruptive of the market but fraught with manipulative potential."<sup>95</sup> To date, however, the Commission has not adopted the proposed rule. It is reported that comments on the proposed rule were generally favorable although several suggested that it was too broad and would create an

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<sup>91</sup> See *SEC v. Harwyn Indus. Corp.*, discussed in note 89 *supra*, and *SEC v. Les Studs Corp.*, CCH FED. SEC. L. REP. ¶ 92,866 (S.D.N.Y. Oct. 5, 1970), in which defendants consented to an injunction.

<sup>92</sup> See *Analysis*, BNA SECURITIES REGULATION & LAW REPORT, Aug. 20, 1969, at B-1.

<sup>93</sup> There are a number of different contexts in which the Commission has held and/or convinced the courts that a distribution is not complete until the shares reach their ultimate purchasers and that conduits to such distribution are underwriters. Perhaps, the most directly related is the holding of the Second Circuit that various persons in the chain of distribution of shares of a shell corporation were underwriters as to shares ultimately sold in the United States although funneled through Canadian conduits. *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63 (2d Cir. 1970). See also *Armstrong, Jones & Co. v. SEC* 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); *Lewisohn Copper Corp.*, 38 S.E.C. 226 (1958).

<sup>94</sup> SEC Securities Exchange Act Release No. 8909 (June 24, 1970).

<sup>95</sup> *Id.*

unreasonable burden on broker-dealers.<sup>96</sup> The influential Investment Bankers Association opposes the adoption of the proposed rule as does the National Quotation Bureau (NQB). In fact, the Commission may prefer to leave the situation vague and rely on specific actions — criminal prosecutions, broker-dealer revocations, suspension of trading and the like — and threats of such action to control the situation.

The NQB presently requires certain minimal information to be furnished to it prior to accepting a quotation relating to an issuer for the first time.<sup>97</sup> It has been reported that the staff of the New York office of the Commission has worked out a procedure with the NQB pursuant to which a security will not be quoted initially until forty-eight hours after the staff has been furnished with the information submitted to the NQB.<sup>98</sup> Presumably, the delay is to permit the staff to make some type of investigation which conceivably might give it a basis for suspending trading in the security. However, in view of the limited delay ordinarily involved, it is doubtful whether such procedures will be effective except in blatant situations.

The proposed rule is designed to restrict the players by requiring prior to quotation by a market-maker that certain minimal information be available in the marketplace. The theory, presumably, is that the availability of such information will discourage both market-makers and the investing public from playing the game. Yet the information called for, although reasonably extensive,<sup>99</sup> could readily be furnished

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<sup>96</sup> BNA SECURITIES REGULATION & LAW REPORT, Nov. 11, 1970, at A-3.

<sup>97</sup> The NQB requires either the submission of prospectus or completion of its form. This form calls for *inter alia*, the name of the corporation, stock's par value, name of transfer agent, available profit and loss statement and whether there is a prospectus or offering circular available. See BNA SECURITIES REGULATION & LAW REPORT, Nov. 11, 1970, at A-2. The NASD automated quotation system is generally limited to securities registered under the Exchange Act, which sell above \$5.00 per share (but which can drop to \$3.00 after authorized for quotation), as to which there are at least two market-makers placing quotations with the system, and which meet other specified requirements. In addition, the corporation established to manage the system can suspend authorization upon specified grounds. CCH NASD MANUAL ¶¶ 1138-1140, 1653A (1970).

<sup>98</sup> BNA SECURITIES REGULATION & LAW REPORT, Nov. 11, 1970, at A-2. The staff, of course, has procedures available to delay the quotation beyond the forty-eight hour period by putting pressures upon the broker-dealer submitting the quotation.

<sup>99</sup> Under proposed rule 15c2-11 as to securities not subject to quotation on a regular basis within the previous thirty days, no dealer, subject to exceptions noted below, could submit a quotation unless the dealer makes available to the quotation system and on demand to anyone expressing an interest in the security the following information: name and address of the issuer; the state of incorporation; the exact title and class of security; the par or stated value of the security; the number of shares outstanding; information concerning the issuer's business and management; name and address of the transfer agent; financial statements (reasonably current); and other information. The information does not have to be furnished as to companies subject to the reporting requirements of the Exchange Act (either because registered under that Act or registered under the Securities Act and having 300 or more shareholders) or as to companies which have recently (as of

without necessarily discouraging the public from playing the so-called numbers game. For one thing, there is no procedure for processing the information or making it readily available to the public. The real enforcer will remain the possibility that such information does not furnish a suitable basis for a broker to make a recommendation<sup>100</sup> and/or that trading in the shell corporation's securities may be held to be per se manipulative.<sup>101</sup>

#### TO SHELL OR NOT TO SHELL

The entire discussion of shell companies has been clouded or enriched (depending upon one's point of view) with emotionally colored words like shell game, phony stock, phony prices, appearance of a fair and bona fide market, representing false business values and the like. Yet, while, as has been said of obscenity, many think they can recognize any of the foregoing categories without being able to define them, there is a need in this area for a less emotional approach to the problems involved. When seen in perspective the desire to use a shell corporation variation rather than being universally motivated by quick buck artists, may be the price some legitimate organizers are prepared to pay in order to have a trading market in their securities. The resulting market price may give them a more realistic basis upon which to make a subsequent public offering of their own and/or upon which to exchange securities for properties or in other forms of acquisitions. In economic terms the price paid may or may not be higher than if they had taken the conventional route which, in the case of a speculative company, is likely to involve as a minimum, cheap stock and warrants to the underwriter or the broker-dealer prepared to make a market in the security. The key to their willingness to pay such a price can be found in the difficulty ordinarily encountered by new companies in developing a trading market for their securities.

The inclination of informed counsel nonetheless, in this context, should be to strongly urge clients, "don't do it." The reasons, in addition to the incurring of SEC disfavor, include the unnecessary dilution involved, the difficulties encountered in finding a clean shell, and the unnecessary costs incurred. Such costs include typically paying a finders-fee, paying for an otherwise worthless control block of stock, and paying for the costs of a thorough investigation to determine the existences of possible contingent or other liabilities.

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the date of the quotation) had a registration statement in effect under the Securities Act or a notification in effect under Regulation A.

<sup>100</sup> See cases cited in note 116 *infra*.

<sup>101</sup> See note 82 and accompanying text *supra*.

If the client considers the foregoing disadvantages and determines, nonetheless, to go this route, what kind of advice should he be given? At the outset, it seems important that all insider stock be appropriately kept out of the market<sup>102</sup> and that trading in the shell corporation stock not be resumed until (a) significant assets have been transferred to the corporation and (b) sufficient public disclosures have been made. One method of accomplishing the latter would be to voluntarily register the company under the Exchange Act.<sup>103</sup> However, in the spin-off situation, nothing less than the 1933 Act registration will satisfy the Commission.<sup>104</sup> In the meantime, it would be necessary to keep the rumor mill from developing and a broker-dealer from commencing trading. Both might be difficult to accomplish; however, the broker might be threatened with the possibility of an SEC trading suspension order. Appropriate restricted legends could be placed on insiders' stock certificates and appropriate instructions could be given to the transfer agent.<sup>105</sup> All reports, letters, etc., distributed to shareholders and/or dealers could be carefully policed. Communications between the issuer and dealers (in particular, market-makers) could be monitored. Realistically, however, there are probably few clients that could be relied upon to accept such restraints and, accordingly, many attorneys are likely to refuse to be involved with a shell corporation.

Assuming that it were possible for the foregoing procedure to be followed, what would the likely impact be on the marketplace? In all probability the price of the security would go up, primarily because the former shareholders see some possibility of salvaging their investment and because of the increased prospects of the company if it now has properties and management of some merit. Is this per se bad? The alternative road to the marketplace is a public offering of securities at an arbitrarily determined price. This price will represent a combination of factors including the general state of the market for speculative securities, the underwriter's distribution machinery, the amount of dilution the public (or Blue-Sky commissioners)<sup>106</sup> will tolerate and the like. If we could assume that the marketplace has the equivalent

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<sup>102</sup> See note 105 and accompanying text *infra*.

<sup>103</sup> Section 12(g)(1) of the Securities Exchange Act, 15 U.S.C. § 78l (g)(1) (1964) permits corporations not required to register under the criteria therein set forth to voluntarily register any class of equity securities.

<sup>104</sup> See note 89 and accompanying text *supra*.

<sup>105</sup> See SEC Securities Act Release No. 5121 (Dec. 30, 1970).

<sup>106</sup> The federal securities laws merely require disclosure in a 1933 Act registration statement of the extent of dilution. See *Richmond Corp.*, SEC Securities Act Release No. 4584 (Feb. 27, 1963). For a summary of relevant Blue-Sky provisions, see Bloomenthal, *supra* note 11, at 1464-66.

information concerning the issuer in our hypothetical reformed shell situation, it is difficult to fault the price-making mechanism in this context. However, as is observed elsewhere,<sup>107</sup> there may be better alternatives if the result is, as it is likely to be, a relatively non-competitive market for the security.

#### THE DISCLOSURE-FRAUD APPROACH AND THE MARKETPLACE

We posit an ideal — a market price determined in a competitive market reflecting supply and demand based on relevant and reliable information as distinguished from a marketplace which is, in effect, a stage managed performance.<sup>108</sup> What are the forces that interfere with this ideal of a free competitive market — a list of same would include the following: (a) An information vacuum — that is, an absence of relevant information concerning the issuer; a vacuum often filled by unsubstantiated rumors; (b) Dissemination of false or misleading information; (c) The withholding of material information (favorable or adverse) that is reasonably certain to affect the market price;<sup>109</sup> (d) The structure of the over-the-counter market in the particular security in terms of the number of dealers making the market and the resources (and interest) of the market-maker; (e) The reliability of the quotations and the quotations system; (f) Market activities of the old-style manipulator — actual purchases and sham transactions designed to create an appearance of activity and to raise the market price; (g) The “merchandising” activities of the retailer.

The first attack on the information vacuum is, of course, the registration requirements of the Securities Act and the Exchange Act and the supplemental reporting requirements.<sup>110</sup> In theory, for such registered securities there is a bank of information available; some of the principal problems here involve retrieving the information. However, in the case of shell companies such information may not be available. This, as we have seen, is one of the Commission's basic

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<sup>107</sup> See discussion commencing at note 166 and accompanying text *infra*.

<sup>108</sup> See Halsey, Stuart & Co., 30 S.E.C. 106, 112 (1949).

<sup>109</sup> The language “reasonably certain to affect the market price” is used advisedly. See discussion at note 121 and accompanying text *infra*.

<sup>110</sup> Securities Act registration requires the filing of a registration statement and the delivery of a prospectus and is applicable generally to public offerings of securities by the issuer or persons controlling the issuer. 15 U.S.C. § 77e (1964). Exchange Act registration requires the filing of information comparable to that required of companies subject to Securities Act registration and is applicable generally to issuers which have \$1,000,000 or more in total assets and a class of equity securities as to which there are 500 or more shareholders of record. 15 U.S.C. § 781(g) (1964). Companies registered under the Exchange Act must file periodic reports to keep the information current, *id.* § 78m, and companies registered under the Securities Act must file similar reports if they have 300 or more shareholders, *id.* § 78o(d).

objections to the utilization of shell companies. In the spin-off variation, the Commission has spun a theory that will require registration under the Securities Act prior to extensive trading in the security.<sup>111</sup> As to other corporate shell situations, insiders often will be selling their personally owned shares in violation of the registration provisions which does not assure the filing of a registration statement but facilitates SEC injunctions<sup>112</sup> and broker-dealer revocation proceedings<sup>113</sup> if a securities dealer is involved.

In the event the vacuum is filled by the rumor mill, there are a number of weapons available. The Commission can and has temporarily (and through a series of such orders over an extended period)<sup>114</sup> suspended trading in the security. A condition for lifting such suspension order is usually the requirement that the issuer release and widely distribute a statement refuting the rumors and setting the record straight. Further, an issuer may even incur a liability for failure to correct rumors of which it is aware.<sup>115</sup> Finally, the Commission has a most effective weapon directed at broker-dealers — revocation proceedings based upon the making of recommendations without an adequate basis for such recommendation. Since many of the activities involved almost necessarily require the participation of a securities dealer, effective policing in this area is an imperative. The Second Circuit has defined the standard — a securities dealer has a special relationship to a buyer of securities and implicitly represents he has an adequate basis for the opinions he renders. The dealer has a duty to avoid the use of unconfirmed rumors and reports as a basis for recommending stock to purchasers.<sup>116</sup>

The dissemination of false or misleading information by securities dealers, issuers and others is also subject to effective policing by the Commission. The information may have been disseminated in the

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<sup>111</sup> See note 89 and accompanying text *supra*.

<sup>112</sup> SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970); SEC v. Mono-Kearsage Consol. Mining Co., [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 90,894. (D. Utah Oct. 8, 1958).

<sup>113</sup> See SEC Securities Act Release No. 4445, SEC Securities Exchange Act Release No. 6721 (Feb. 2, 1962). Compare Quinn & Co., SEC Securities Exchange Act Release No. 9062 (Jan. 25, 1971).

<sup>114</sup> See note 78 *supra*. For an instance in which the order suspending trading in stock of a shell corporation remained in effect for in excess of nine months and was not lifted until after an injunction against further violations was obtained, see Capitol Holding Corp., SEC Securities Exchange Act Release No. 8730 (Oct. 23, 1969).

<sup>115</sup> Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989 (1970). See also as to securities listed on the New York Stock Exchange, *Guidelines for Timely and Adequate Disclosure of Corporate News*, NEW YORK STOCK EXCHANGE COMPANY MANUAL A-23 (1968).

<sup>116</sup> Hillier v. SEC, 429 F.2d 856 (2d Cir. 1970); SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970); Hanly v. SEC 415 F.2d 589 (2d Cir. 1969).

form of progress reports, shareholder letters, news releases and the like issued by the company or research reports issued by broker-dealers and/or investment advisers. With respect to broker-dealers and investment advisers the Commission can utilize its power of revocation;<sup>117</sup> with respect to issuers the Commission can seek to enjoin the use of the information even when only negligently (as distinguished from intentionally) misrepresented.<sup>118</sup> The fraud and manipulation provisions are so intertwined that they cannot be placed in separate categories — false or misleading statements may not be part of a scheme to affect market prices; this is a reasonable assumption if negligently made. On the other hand, if intentionally made the reasonable assumption is a scheme to affect market price. Insofar as an SEC obtained injunction is concerned, scienter in this context is immaterial; with respect to private actions it may be relevant.<sup>119</sup> The Commission in this area can also, of course, use its power to suspend trading in the security.

The withholding of material information suggests, of course, the *Texas Gulf Sulphur* case and is a subject so widely discussed<sup>120</sup> in the literature we make only brief reference to it here. While treated generally as a fraud problem, again it cannot be entirely separated from market manipulations. In fact, the test of materiality generally suggested in this area recognizes that what we are concerned with here is the withholding of information that is reasonably certain to affect the market price of the security (up or down).<sup>121</sup> We know that the Com-

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<sup>117</sup> Section 15(b)(5) of the Exchange Act, 15 U.S.C. § 78o(b)(5) (1964), authorizes the revocation of registration of broker-dealers for violations of the Securities Act or Exchange Act, and section 203(d)(D) of the Investment Advisers Act, 15 U.S.C. § 80b-3(d)(D) (1964), authorizes revocation of registration of an investment adviser on similar grounds. See *Levine v. S.E.C.*, 436 F.2d 88 (2d Cir. 1971); *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), for cases involving broker-dealer revocation. For an investment adviser revocation proceeding see *Roman S. Gorski*, SEC Investment Advisers Act Release No. 214 (Dec. 22, 1967).

<sup>118</sup> *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). On remand the district court concluded that the press release was misleading and that the company officials had failed to exercise due diligence in its preparation but declined to issue an injunction on the grounds that in view of the passage of time and other factors further violations were not likely. *S.E.C. v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77 (S.D.N.Y. 1970).

<sup>119</sup> See discussion commencing at note 152 and accompanying text *infra*.

<sup>120</sup> See, e.g., Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications*, 22 Sw. L.J. 731 (1968); Navin, *Insider's Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities*, 78 YALE L.J. 864 (1969); Ruder, *Texas Gulf Sulphur—The Second Round: Privy and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. REV. 423 (1968).

<sup>121</sup> The majority opinion in *Texas Gulf Sulphur* defined materiality both in terms of events which are "extraordinary in nature" and "reasonably certain" to affect market prices, 401 F.2d at 848, and facts which "might affect" market price. *Id.* at 849. Further, in the same opinion the court talked about materiality in terms of facts which "may affect the desire of investors to buy, sell, or hold the company's securities. . . ." *Id.* While the latter two statements of materiality may require greater disclosure, it seems to the



mission can act by seeking an injunction and to the extent a broker-dealer is involved through broker-dealer revocation proceedings provided insiders are contemporaneously purchasing or selling their own securities.<sup>122</sup> The extent that an issuer has an affirmative obligation to disclose such information absent insider trading has not been determined. The Commission's reporting requirements are neither timely enough nor extensive enough to effectively require such disclosures.<sup>123</sup> Companies with securities listed on the New York and American Stock Exchanges as part of their listing agreement or otherwise commit themselves to generally make such timely disclosure.<sup>124</sup> There may yet be determined under existing statutory provisions and appropriate rules an affirmative duty to make such disclosure, at least if it can be established that the information has been withheld because of its likely impact on the market price of the security.<sup>125</sup> It is difficult to understand why the Commission has not acted in this area by the adoption of an appropriate rule and it may yet do so.<sup>126</sup>

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author and to others (including Phillip A. Loomis, the Commission's General Counsel) that in this context all that should be expected is disclosure of information reasonably certain to have an immediate and substantial effect on market price. For the Loomis remarks, see [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,624 (1968). See also Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965).

<sup>122</sup> S.E.C. v. Great Am. Indus. Inc., 407 F.2d 453 (2d Cir. 1968), cert. denied, 395 U.S. 920 (1969); S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

<sup>123</sup> Form 8-K which is the appropriate form for filing current developments by companies subject to the reporting requirements, see note 111 *supra*, does not have to be filed until ten days after the month in which the event occurs. 17 C.F.R. § 240.13a-11 (1970). Further, it does not call for disclosure of the type of information involved in the *Texas Gulf Sulphur* case although the reporting company may at its option include events which have occurred during the past month "which the registrant deems of material importance to security holders." Form 8-K, item 12.

<sup>124</sup> See NEW YORK STOCK EXCHANGE COMPANY MANUAL A-18 through A-27 (1968); CCH AMEX. COMPANY GUIDE §§ 401-406 (1970).

<sup>125</sup> In *Texas Gulf Sulphur*, the court indicated that the timing of disclosure is a matter for business judgment at least if the withholding of information serves a corporate purpose. 401 F.2d 833 n.12. However, a district court has regarded as actionable and appropriate for submission to a jury the withholding of information by insiders in the event such information has been withheld as part of a scheme to artificially maintain the market price of a security. *Financial Indus. Fund, Inc. v. McDonnell-Douglas Corp.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,760 (D. Colo. Aug. 13, 1970). See also *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969), in which the court refused to dismiss on motion for summary judgment the claim of plaintiffs based on defendant corporation's failure to disclose material information during the period subsequent to the date upon which no corporate purpose was apparently served by further withholding the information and dismissing claims based on transactions prior to such date.

<sup>126</sup> The Commission on October 15, 1970 reiterated its view as to "the need for publicly held companies to make prompt and accurate disclosure of information, both favorable and unfavorable, to security holders and the investing public. . . ." However, while pointing out that failure to make such disclosures may constitute a violation if the

The structural market problem involves primarily the so-called controlled and dominated market. Any market, in which there is essentially only one dealer making the market, is potentially a candidate for a broker-dealer revocation proceeding, as the proof in this type of case typically consists of a statistical analysis showing participation by that dealer in a large percentage of all trading transactions pertaining to the security over a given period of time. The thin line between permitted and illegal markets in this area is, to say the least, a gray one. To the extent the problem relates to the precarious situation created for investors in the event the only market-maker withdraws from the market, disclosure of this fact may be helpful. However, to the extent such markets fail to achieve the posited ideal there appears to be no consensus as to a viable alternative. The problem is one aspect of the larger problems relating to access by unseasoned companies to the marketplace. Yet, as the *Special Study* seemed to accept,<sup>127</sup> such a market may well be better than no market at all if not accompanied by some of the other market distorters discussed herein. Some of the alternatives are discussed below.<sup>128</sup>

Closely related to the problem of the controlled and dominated market is the reliability of the quotation system. In terms of making information available concerning quotations, the automatic quotation system initiated by the NASD is a welcome and significant advancement. However, some of the basic problems will remain and require policing. These include fictitious quotations; inducing others to furnish quotations which in effect are backed by a single market-maker, lack of reliability as to the quotations in terms of number of shares the dealer is prepared to purchase and the like. The fictitious quotation and furnishing quotations for others are subject to regulation and policing, but there are no established rules as to the extent to which a dealer has to be prepared to purchase or sell securities at the quoted price.<sup>129</sup> In addition, the existing quotation systems are in private

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corporation is purchasing its own securities or insiders are trading in its securities and that the rules and directives of the major exchanges require such disclosures, the Commission persists in refraining from adopting a rule that would spell out such requirements generally and specify the circumstances requiring and the timing of such disclosures. See SEC Securities Act Release No. 5092, SEC Securities Exchange Act Release No. 8995, SEC Investment Company Act Release No. 6209 (Oct. 15, 1970).

<sup>127</sup> SEC SPECIAL STUDY REPORT, pt. 2, at 661-62, 673. The *Special Study* did recommend that "[a] broker-dealer soliciting a customer's purchase of any security for which there is no independent market other than its own, or any security out of its own inventory, or any security in which there is a spread of, say, 20% or more in prevailing inter-dealer bids and offers, should be required to disclose such fact or facts at the time of solicitation. . . ." *Id.* at 673.

<sup>128</sup> See 636 *et seq. infra*.

<sup>129</sup> See rule 15c2-7, 17 C.F.R. § 240.15c2-7 (1970); *Rules of Fair Practice of the NASD*,

hands and the extent to which entry into the system is regulated is informal and inadequate. The Commission has acted timidly in this area; the only attempt to regulate such entry by rule has yet to be adopted and faces powerful opposition.<sup>130</sup> Such inadequacies encourage and facilitate over-the-counter market manipulations.

The framers of the Exchange Act thought of manipulation largely in terms of effectuating a series of transactions at rising prices, thereby creating an appearance of activity designed to induce others to enter the marketplace adding to the pressure for higher prices. The Commission has adequate authority in this area both with respect to over-the-counter and listed securities which permit revocation of broker-dealer registration and injunctive action against other manipulators. The problem in this context is the extensive surveillance and investigation that have to be employed to police this type of activity and difficulties encountered in proving wrongful conduct involving questions of motivation. However, in the latter regard in the broker-dealer revocation area, as we have previously seen,<sup>131</sup> the Commission has gone a long way in drawing the inferences necessary to support a violation.

"Merchandising" of securities overlaps with a number of the foregoing. Obviously, to the extent false or misleading representations, the withholding of inside information, recommendations without an adequate basis, violations of the registration provisions, or controlled or dominated markets or the like are involved the factors discussed above are pertinent. Since "merchandising" is often accompanied by such activities, it is somewhat artificial to attempt to isolate it as a separate basis for violation. However, the inherent conflict of interest involved has at long last been recognized to a degree in the *Chasins* case requiring, if the dealer knows the customer is relying on its recommendation, disclosure of the fact that the dealer acting as principal and recommending the security for purchase is also making a market in the security. As suggested below, however, one may question whether disclosure is adequate to deal with the problems raised in this context.

#### PRIVATE ACTIONS

The experience under section 16(b), which is enforceable only through private actions, demonstrates the efficacy of such actions in

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art. III, § 5, CCH NASD MANUAL ¶ 2155 (1970). See also *NASD Board of Governors Policy with Respect to Firmness of Quotations*, *id.* at ¶ 2156; *Franklin Nat'l Bank v. L.B. Meadows & Co.*, CCH FED. SEC. L. REP. ¶ 92,940. (S.D.N.Y. June 25, 1970).

<sup>130</sup> Proposed rule 15c2-11, see discussion commencing at note 95 and accompanying text *supra*.

<sup>131</sup> See note 64 and accompanying text *supra*.

promoting compliance with the federal securities laws.<sup>132</sup> Accordingly, private actions for damages and/or injunctive relief for unlawful activities that affect the market price of securities, may constitute a significant policing factor and deterrent. If the private party has purchased securities from his broker-dealer and the broker-dealer is a participant in such activities, the private party is likely to have a remedy. In fact, the name of the game often is when to sue one's dealer<sup>133</sup> since they are generally liable in private actions for violation of the federal securities laws<sup>134</sup> (and related regulations) and in some instances for violations of the rules of the exchange of which they are a member and/or of the NASD.<sup>135</sup> The effectiveness of private actions in this area depends upon the ability to prove the violation and the financial solvency of the dealer.<sup>136</sup>

If the broker-dealer had engaged in a series of transactions designed to affect the market price of the security, liability with respect to listed securities is expressly provided for under the Exchange Act to all persons who purchased the security at a price affected by these activities and who has been damaged.<sup>137</sup> The scope of a section 10(b) action is undoubtedly as great with respect to a similar situation involving an unlisted security.<sup>138</sup> Similarly, there is little question as to a broker-dealer's liability to a customer for securities purchased (or sold) which are misrepresented or recommended without an adequate basis. If a broker-dealer withholds information and is an insider as that term has been broadly-defined, he undoubtedly has liability to someone

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<sup>132</sup> Section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1964), authorizes in a private action recovery on behalf of the corporation of short-swing profits realized by insiders; it does not make such transactions unlawful.

<sup>133</sup> A consumer's newsletter in a recent article, citing chapter and verse (including the *Chasins* case), refers readers to several securities lawyers in a number of metropolitan areas. *How Dishonest Is Your Stockbroker?*, MONEYSWORTH, Feb. 8, 1971, at 1.

<sup>134</sup> *Chasins v. Smith, Barney & Co.*, CCH FED. SEC. L. REP. ¶ 92,962 (2d Cir. Mar. 2, 1971). The cases are numerous and many of them are collected and cited in *Franklin Nat'l Bank v. L.B. Meadows & Co.*, CCH FED. SEC. L. REP. ¶ 92,940 (S.D.N.Y. June 25, 1970).

<sup>135</sup> *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969). Compare *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966).

<sup>136</sup> The Securities Investor Protection Corporation Act of 1970, see note 10 *supra*, probably does not afford additional direct protection since it is designed to protect accounts of customers and a claim for damages is not an account. However, reserve and other requirements of the Act conceivably could generally contribute to the financial solvency of dealers.

<sup>137</sup> Securities Exchange Act of 1934, § 9(e), 15 U.S.C. § 78i(e) (1964).

<sup>138</sup> *Klein v. Auchincloss*, 436 F.2d 339 (2d Cir. 1971); *Davis v. Pennzoil Corp.*, 438 Pa. 194, 264 A.2d 597 (1970). Compare *Franklin Nat'l Bank v. L. B. Meadows & Co.*, CCH FED. SEC. L. REP. ¶ 92,940 (S.D.N.Y. June 25, 1970), holding a broker-dealer liable for violations of rule 15c2-7, 17 C.F.R. § 240.15c2-7 (1970), pertaining to fictitious quotations even in the absence of privity. See also notes 60, 129 and accompanying text *supra*.

while trading in the security<sup>139</sup> although as in the case of other insiders to whom and to what extent remains to be determined.<sup>140</sup> If the broker-dealer has such information available and withholds it but refrains from trading, he may, nonetheless, be liable to those that purchase (or sell, as the case may be) when such information is withheld in order to affect the market price.<sup>141</sup>

In the area of "merchandising" of securities, a broker-dealer who recommends the security without an adequate basis is liable to the customers purchasing the security from him.<sup>142</sup> The broker-dealer may be liable if he fails to disclose that he has a material position in the security being recommended,<sup>143</sup> or if he knows that the client is relying on his recommendation that he is making a market in the security,<sup>144</sup> or that he is the only market-maker with respect to the security,<sup>145</sup> or that he has a controlling interest in the issuer.<sup>146</sup> We have probably seen only the beginning of private litigation in these areas.

In the broker-dealer area many of the situations referred to above involve privity — that is, the plaintiff will have purchased from or sold the security to the defendant broker-dealer. With respect to private actions brought against the issuer or persons associated with the issuer, privity in this context is likely to be absent. As to the traditional type of manipulation involving a series of transactions designed to raise (or lower) the market price of a listed security, section 9(e) of the Exchange Act expressly imposes liability on the manipulator irrespective of privity.<sup>147</sup> Similarly, as suggested above, liability can be imposed under

<sup>139</sup> Rule 10b-5 upon which liability is predicated is applicable to "any person" and a broker-dealer may be a corporate insider. *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). While *Cady, Roberts* doesn't determine the question of a broker-dealer's liability, there is no basis to expect that broker-dealers can escape liability in view of the fact that it is imposed on other insiders, see note 149 *infra*, and in view of the general predilection of courts to impose liability on broker-dealers, see note 133 *supra*.

<sup>140</sup> See discussion commencing at note 149 and accompanying text *infra*.

<sup>141</sup> A jury has awarded damages to a plaintiff in the amount of \$712,500 against an issuer and a broker-dealer who allegedly withheld unfavorable information from the marketplace in order to maintain the price of the security at an artificial level. The security was purchased in the open market and there was no privity between the plaintiff and defendants. See *Financial Indus. Fund, Inc. v. McDonnell-Douglas Corp.*, CCH FED. SEC. L. REP. ¶¶ 92,760 & 92,811 (D. Colo. Aug. 13, 1970 & Sept. 20, 1970).

<sup>142</sup> See cases cited in note 117 *supra*.

<sup>143</sup> But see *SEC v. R.A. Holman & Co.* 366 F.2d 446 (2d Cir. 1966), and Judge Friendly's opinion in *Chasins*, CCH FED. SEC. L. REP. ¶ 92,962 at 90,560.

<sup>144</sup> See discussion of the *Chasins* case commencing at 610 *supra*.

<sup>145</sup> *Id.*

<sup>146</sup> See rule 15c1-5, 17 C.F.R. § 240.15c1-5 (1970), which requires such disclosures.

<sup>147</sup> 15 U.S.C. § 78i(e) (1964). Compare *Franklin Nat'l Bank v. L.B. Meadows & Co.*, CCH FED. SEC. L. REP. ¶ 92,940 (S.D.N.Y. June 25, 1970), holding that an implied cause of action may be brought by one damaged by fictitious quotations placed in violation of rule 15c2-7, 17 C.F.R. § 240.15c2-7 (1970), even in the absence of privity.

section 10(b) as to unlisted securities and with respect to listed securities when the short statute of limitations provided for by the Exchange Act has run.<sup>148</sup> There have not been a significant number of private actions relating to activities of this type undoubtedly because such activities are difficult to prove.

With respect to the failure to disclose material current developments reasonably certain to affect the market price of the security, the law is currently developing and can be capsuled only at considerable risk of being modified tomorrow. Insiders who trade on the basis of such undisclosed information are clearly liable, but the extent to which and to whom remains to be determined.<sup>149</sup> The corporation probably does not have any liability for the failure to disclose such information provided there is an appropriate corporate reason for withholding such information.<sup>150</sup> Absent such appropriate reason and/or if the information is being deliberately withheld because of its probable impact on the market price, the corporation may very well be liable to those purchasing or selling the security during the relevant period.<sup>151</sup>

In the area of manipulation through "touting" — that is, the spreading of false or misleading information, the law also is not fully developed. Here we meet two — consistent in theory but not in application — policy considerations. First, the desire to encourage issuers and other concerned persons to widely disseminate corporation information; second, the avoidance of false or misleading information designed to run up (or down) the price of the stock. Accordingly, if the issuer or those associated with it are disseminating information which is relied upon by those purchasing in the market, it is likely that absent privity (the usual situation in this context) that liability will be im-

<sup>148</sup> Klein v. Auchincloss, 436 F.2d 339 (2d Cir. 1971).

<sup>149</sup> In the original *Texas Gulf Sulphur* proceeding the Commission requested that insiders who purchased TGS stock in violation of rule 10b-5 be required to make restitution to the persons who sold to them. However, when relief was finally granted, the court approved the Commission's suggestion that individual defendants be required to pay in the amount of their (and also their tippees') profits to the corporation. The amounts paid in are to be held in escrow by the corporation in an interest-bearing account for a period of three years subject to disposition as directed by the court upon application of the SEC or other interested person or on the court's own motion. See *S.E.C. v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77 (S.D.N.Y. 1970). See also *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969). Compare *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 210, 301 N.Y.S.2d 78 (1969), in which recovery by the Corporation was allowed for profits realized by insiders on the basis of trading on inside information as a common-law derivative action.

<sup>150</sup> See note 125 *supra*.

<sup>151</sup> See notes 125 and 141 *supra*. Failure of the issuer to report to appropriate regulatory authorities activities of a broker-dealer which it knew had the effect of artificially increasing the price of the issuer's stock has been held in the particular circumstances of the case to constitute aiding and abetting a violation of rule 10b-5. *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

posed only if (a) plaintiff relied on the false or misleading information, (b) defendants could have foreseen such reliance and (c) some form of scienter is present.<sup>152</sup> The real debate in this area will probably be over the type of scienter required — mere knowledge as distinguished from wrongful motive.<sup>153</sup> The author would suggest that in this context knowledge of the relevant facts should not be enough; the knowledge required in this context should be that the information as presented is misleading. Knowledge that it is misleading suggests motive (that is intent to deceive) and motive suggests knowledge that the material is misleading.<sup>154</sup> In any event, such conclusions are likely to be based on inference which is not inappropriate. However, those who have responsibility for the preparation and dissemination of corporate information should not face unlimited liability for essentially innocent or at its worse negligent conduct in preparing information which in retrospect is judged to be misleading.

There are a number of persons who are adversely affected economically in fact by manipulative activities, but who may have no cause of action because they have neither purchased nor sold the security in question as a result of the manipulative activities. The courts in several different contexts have been struggling with the *Birnbaum* proposition that section 10(b) of the Exchange Act protects only defrauded purchasers or sellers of securities.<sup>155</sup> The doctrine is said to be much weakened generally,<sup>156</sup> but yet it lives on in many areas.<sup>157</sup> One thing appears reasonably clear and that is shareholders

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<sup>152</sup> *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *Reynolds v. Texas Gulf Sulphur Co.*, 309 F. Supp. 566 (D. Utah 1970); *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969).

<sup>153</sup> See discussion of this issue in *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. at 1343-44. See also *Cannon v. Texas Gulf Sulphur Co.*, CCH FED. SEC. L. REP. ¶ 92,944 (S.D.N.Y. Feb. 5, 1971).

<sup>154</sup> In the author's view, the issue in this context differs from (and hence shouldn't be controlled by) those cases which disagree on whether scienter is necessary in an action based on rule 10b-5 in order to reconcile allowing actions under this provision which would otherwise duplicate express causes of action under sections 11 and 12(2) of the Securities Act, 15 U.S.C. §§ 77k, 77l(2) (1964). Compare *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) (requiring scienter), with *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961) (dispensing with a scienter requirement in that context). The author finds the view expressed by Judge Friendly, concurring in *Texas Gulf Sulphur*, as persuasive on this point. 401 F.2d at 866-67. The following type of finding would appear both appropriate and essential: "[T]he press release issued by defendants was misleading, intentionally deceptive, inaccurate and knowingly deficient in material facts pertaining to the results of drilling . . . ." *Reynolds v. Texas Gulf Sulphur Co.*, 309 F. Supp. at 562.

<sup>155</sup> *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

<sup>156</sup> See *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

<sup>157</sup> See *Greenstein v. Paul*, 400 F.2d 580 (2d Cir. 1968), holding that a shareholder has no action for alleged siphoning of corporate assets by defendants in order to depress

who neither sell nor purchase may bring a private injunctive action to enjoin manipulative activities that are continuing and adversely affect them. Thus, they may enjoin a continuing unlawful scheme to depress the market price of their shares, but absent some special circumstances probably cannot recover damages.<sup>158</sup> The Commission is attempting as *amicus curiae* to convince the courts that *Birnbaum* should be overruled in this respect and that a plaintiff's right to bring an action should be based upon (1) whether plaintiff has been harmed and (2) whether the harm was caused by an actionable wrong on the part of the defendant rather than the artificial criterion of whether the plaintiff is a purchaser or seller of securities.<sup>159</sup> The logic of the Commission's position appears to be persuasive and, if adopted, should eliminate in the context of private actions involving alleged manipulative activities much of the hasseling and maneuvering that now goes on in terms of whether the plaintiff as a non-seller or non-purchaser has standing.<sup>160</sup>

In the particular area of shell corporations and spin-offs, private actions are available to the extent there has been a violation of the registration provisions of the Securities Act.<sup>161</sup> If, as is often the case, manipulative market practices are involved, the remedies discussed above are available, but as there noted, the type of investigation required

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market price, and *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970), holding plaintiff has no action against defendant who allegedly frustrated plaintiff's tender offer through false representations that induced shareholders not to accept the tender offer. *But compare* cases in note 158 *infra*: *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962).

<sup>158</sup> *Mutual Shares Corp. v. Genesco*, 384 F.2d 540 (2d Cir. 1967), where a non-selling shareholder was denied damages, but granted injunctive relief. *See also* *Puharich v. Borders Elec.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,141 (S.D.N.Y. Jan. 24, 1968), which allowed injunctive relief under similar circumstances. *Compare* *Crane Co., v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970), which allowed plaintiff to recover damages although neither a purchaser nor seller for defendant's manipulation designed to raise the market price of the security in question for the purpose of frustrating plaintiff's tender offer, the court stating that the manipulation had caused injury to plaintiff and remanding to the district court to determine the extent of the damage. *Id.* at 797. However, the case can be reconciled with the purchaser or seller requirement in that the court concluded that because of the requirements of the antitrust laws the plaintiff was required to divest itself of the shares acquired as a result of its generally unsuccessful tender offer and hence was a forced seller.

<sup>159</sup> *See* Brief for SEC as *Amicus Curiae*, *Levine v. Seilon, Inc.*, 436 F.2d 88 (2d Cir. 1971); BNA SECURITIES REGULATION & LAW REPORT, Jan. 20, 1971, at E-1.

<sup>160</sup> The cases cited in notes 157 and 158 *supra*, are only illustrative of the litigation dealing with the preliminary question of whether the plaintiff has an appropriate interest to maintain the action. *See* *Ernst & Ernst v. United States Southern District Court of Texas*, CCH FED. SEC. L. REP. ¶ 92,953 (5th Cir. Feb. 25, 1971), for the type of maneuvering involved. For a discussion of a similar question in the related context of derivative actions which now appears to be finally resolved, see Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement*, 15 N.Y.L.F. 332 (1969).

<sup>161</sup> Securities Act of 1933 § 12(1), 15 U.S.C. § 771(1) (1964).



may be too extensive to make proof feasible. It is unlikely, however, that a market manipulation is not being accompanied by the dissemination of false or misleading information and the entire arsenal of private remedies against the broker-dealer, issuer and associated person are available in this situation. The principal limitation, however, may very well be that by the time the investors realize that they have been duped there is no financially responsible defendant available to sue.

The foregoing actions often can be facilitated by the bringing of a class action. The subject of class actions is beyond the scope of this article; suffice it to say that the liberal application of the revised federal rule pertaining to class actions has tremendous promise and significance in terms of making more effective enforcement and compliance with federal securities laws generally and those pertaining to fraud and manipulation in particular.<sup>162</sup>

#### BEYOND DISCLOSURE-FRAUD

The "merchandising" of securities in secondary markets presents problems which, despite the formidable and numerous theories requiring disclosure and/or upon which liability may be imposed at the instance of both private and public enforcers, do not lend themselves to effective control through the disclosure-fraud apparatus. In the author's judgment the overall impact of the disclosure-fraud approach will remain peripheral and uneven, in part because it fails to come to grips with the real problems and in part because disclosure is not likely to be effective.

What type of disclosure is likely to be required and at what point must it be made? Obviously, if it is to be effective it must be prior to the completion of the transaction. To the extent the recommendations involved are written the disclosure will probably consist of statements to the effect that the broker-dealer from time to time maintains a position in the security (long or short) and makes a market in the security. If the broker-dealer is the only market-maker, this fact would also have to be disclosed and in those instances in which the broker-dealer controls the issuer this fact must also be disclosed.<sup>163</sup> Conceivably when all four disclosures are required the cumulative effect might in itself deter investors; generally, however, the average speculative investor is not going to be deterred by the disclosure that his broker-dealer main-

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<sup>162</sup> See *Dolgow v. Anderson*, 438 F.2d 825 (2d Cir. 1970), *modified, id.* at 833 (2d Cir. 1971), for an illustration of the possibilities in this regard. See also *Bernfeld, Class Actions and Federal Securities Laws*, 55 CORNELL L. REV. 78 (1969).

<sup>163</sup> See discussion commencing at 629 *supra*. As to disclosure of the broker-dealer's control of the issuer, see rule 15c1-5, 17 C.F.R. § 240.15c1-5 (1970).

tains a position in the security and makes the market in the security.<sup>164</sup> In fact, if he is sophisticated enough to conclude that his broker-dealer is really pushing the particular security he may be encouraged to buy it in the expectation that the broker's activities are going to carry the price to a higher level.<sup>165</sup>

If the recommendation is made over the telephone, the disclosure will be made too late to be effective. This will be true in many instances even though from a legal standpoint the transaction is not completed until some period of time after the disclosure. In *Chasins*, the court declined to address itself to the question of the best mechanics for disclosure. However, to the extent disclosure is required, the disclosure undoubtedly has to be prior to the completion of the transaction.<sup>166</sup> One method of doing this would be to allow the purchaser a period of time (perhaps twenty-four hours) after receipt of the confirmation accompanied by the disclosure in which to renounce or reaffirm the transaction. Disclosure in concrete specific terms directed to a particular security and spelling out some of its implications is likely to be more effective than one cast in general terms.<sup>167</sup> Further,

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<sup>164</sup> Interestingly enough, the manager of the trading department of Smith, Barney & Co. testified in the *Chasins* case that "[f]rom the point of view of the knowledgeable investor, disclosure to him that he would be purchasing from a market-maker would only have encouraged him in his decision to buy." CCH FED. SEC. L. REP. ¶ 92,962, at 90,561.

<sup>165</sup> Which probably accounts for the fact that as to listed securities section 9(a)(3) of the Exchange Act expressly makes it unlawful to induce the purchase or sale of a security by representing that one's market operations will result in the price of a security rising or falling. 15 U.S.C. § 78i(a)(3) (1964).

<sup>166</sup> This is the requirement in the comparable situation with respect to disclosure of the broker-dealer's control of the issuer which must be disclosed before entering into a contract with the customer. Rule 15c1-5, 17 C.F.R. § 240.15c1-5 (1970). Interestingly, the *Special Study* thought of reaching the "merchandising" problem described in this article primarily in terms of requiring in market letters, progress reports and the like, disclosure of the fact that the recommending dealer has a position in the security and makes a market in the security. SEC SPECIAL STUDY REPORT, pt. 1, at 385-86. Both the New York Stock Exchange and the NASD have adopted requirements applicable to their respective members designed to implement this recommendation. 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2474 A. 10 (1970); CCH NASD MANUAL ¶¶ 2017-2020, 2151.01 (1970). In most instances the disclosures are on the bottom of a report containing several recommendations and are made in such general terms that they probably are not very effective. In fact, in the *Chasins* case, the plaintiff as to one of the securities involved had received a research report which included the following typical legend: "We point out that in the course of our regular business we may be long or short of any of the above securities at any time." CCH FED. SEC. L. REP. ¶ 92,962, at 90,561.

<sup>167</sup> A disclosure that might be meaningful would be the following:

We call your attention to the fact that we are the principal market-maker in the common stock of XYZ Corporation. In the event, we should discontinue making a market in this security it may not be possible for you to sell it in normal brokerage channels and the market price of the security might be seriously affected. As a market-maker we have a potential conflict of interest with customers to whom we recommend the security as at any given time depending upon our position in the security it may be to our interest to recommend to you the purchase

requiring the transaction to be reaffirmed rather than renounced may have a different practical impact. None of these matters are likely to be specifically spelled out by way of judicial decision although they do lend themselves to the Commission's rule-making powers and apparently are being currently considered by the Commission.<sup>168</sup>

There will be no effective regulation of "merchandising" until some basic structural changes occur in the over-the-counter market. The lesser of these changes is to preclude a dealer making a market in a security from executing orders for his customers except as agent for his customer and through some other dealer's market. However, with reciprocity being what it is in the securities industry this is not likely to be wholly effective.<sup>169</sup> The more drastic and more realistic change would be to require the separation of the wholesaler and retailer function at least as to the same security. The result would be to preclude a dealer, making a market in a security, from also recommending the security to its customer. While the author is not naive enough to believe that wholesale dealers wouldn't still attempt to influence retailers in their recommendations,<sup>170</sup> other steps could then be taken to reach various forms of inducements that wholesalers might hold out to retailers and their sales forces.

The real problems, however, in this area involve the dealer's inherent conflict of interest and the impact of "merchandising" on securities prices. *Chasins* is the first judicial recognition of the former problem, the court stating bluntly that the evil involved "is that recommendations to clients will be based upon the best interests of the dealer

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or sale of the security. Accordingly, our recommendations of this security should not be regarded as a disinterested one.

<sup>168</sup> Section 15(c)(1) of the Exchange Act, 15 U.S.C. 78o(c)(1) (1964), expressly authorizes the Commission to define by rules and regulations practices which if engaged in by a broker-dealer shall be deemed to be manipulative, deceptive or otherwise fraudulent.

<sup>169</sup> The interpositioning cases are a good illustration of how dealers are prone to use give-ups and other reciprocity arrangements to compensate one another indirectly for what they cannot do directly and often at the customer's expense. See, e.g., Thompson & McKinnon, SEC Securities Exchange Act Release No. 8310 (May 8, 1968). It is, of course, possible to engage in a manipulation and execute transactions on an agency basis. See cases cited in note 53 *supra*, all of which involve manipulation of listed securities; for an over-the-counter agency manipulation, see S.T. Jackson & Co., 36 S.E.C. 631 (1950).

<sup>170</sup> As in interpositioning, the compensation might consist in some manner in making reciprocal business available. Nor, of course, would the proposal eliminate the incentive of the wholesaler to manipulate the market price of the security. Thus, in Stone, Summers & Co., SEC Securities Exchange Act Release No. 8885 (May 15, 1970), the broker-dealer charged with manipulating the market price of shares of several corporate shells publicly defended its activities by claiming that all of its sales were made to professional brokers only. See CCH FED. SEC. L. REP. News Letter, May 20, 1970, at 2-3. To the extent wholesale dealers attempt to induce others to recommend the stock in return for some form of undisclosed compensation, such activities could probably be reached by the anti-fraud provisions. See SEC v. Torr, 15 F. Supp. 315 (S.D.N.Y. 1936).

rather than the client . . . ."<sup>171</sup> The *Special Study* recognized the latter problem in the context of the dominated market as one in which prices "may be affected by the firm's own activity at the retail level."<sup>172</sup> A prophylactic approach — that is, one designed to prevent the conflict of interest and the interference with market prices — is essential.

One might ask what distinguishes this type of "merchandising" from the sale of securities generally which after all in any event involves selling effort by retail dealers and their registered representatives. It needs to be acknowledged that all selling effort based upon earning commissions includes its own inducement to engage in fraudulent or puffing statements. However, the dangers are especially acute in the case of a "merchandised" security not only because of the special rewards available but also because the salesman no longer is performing his function of assisting the client in making a choice among competing choices. In the typical trading transaction the salesman may be interested in inducing the client to make a purchase in order to earn a commission, but he is quite indifferent to the security being purchased and hence can to that extent be objective about its selection. In fact, his own self-interest in this context dictates as wise a selection as possible; a satisfied customer will come back whereas a dissatisfied one may turn out to be the plaintiff in a forthcoming lawsuit against the salesman and the firm. In the case of a "merchandised" security the firm's and the salesman's own conflict of interest often precludes the integrated firm from making a disinterested recommendation.

The existence of "merchandising" in the secondary market undoubtedly contributes to the type of speculative frenzy that results in accentuating swings in stock price levels. The Commission's approach to the problem has been piecemeal and largely ineffective. In fact, the Commission contributes to these accentuated fluctuations because its policy of emphasizing the negative discourages stock purchases in speculative enterprises at opportune times, whereas it arrives on the scene too late and with ineffective weapons to curb a speculative frenzy once it is underway.<sup>173</sup> At best the Commission's efforts reach only the periphery of the problem.

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<sup>171</sup> CCH FED. SEC. L. REP. ¶ 92,962, at 90,559.

<sup>172</sup> SEC SPECIAL STUDY REPORT, pt. 2, at 588.

<sup>173</sup> Since this is a law review article, presumably, footnotes are required. However, one cannot readily cite authoritative sources for what essentially is an assertion based on approximately twenty years of observation. Some of the limitations on the Commission's ability to deal with speculative markets is reflected in the *Special Study Report*. SEC SPECIAL STUDY REPORT, pt. 1, at 261-90. The author suggests that the yet to be written history of the financing of exploration for uranium in the United States would provide some appropriate documentation. In the early 1950's, the Commission's staff discouraged

The proposal to separate the wholesale and retail phase of the securities business is not, of course, a new one.<sup>174</sup> If its sweep proves to be too broad in the sense that it encompasses operations that do not pose the evil raised, exclusions from its sweep under appropriate safeguards can be provided for. One possibility in this respect could be to exclude broker-dealers who give adequate assurance that their trading departments are completely insulated from their retail departments.<sup>175</sup> Special consideration in this context must be given to the appropriate role of the broker-dealer's research department. Such departments can be and have been utilized as an adjunct to the type of merchandising activities condoned in this article; on the other hand the disinterested advice of such a department may be essential if registered representatives are to make informed recommendations to customers. Further, it would be inappropriate to deny a dealer the benefit of the research group's knowledge in determining whether to make a market in a security in the first instance or as to day-to-day trading in the security.

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uranium exploration and those with the foresight to be looking for uranium had difficulty in financing exploration activities. The author bears witness as he acknowledges that as a member of the staff he shared a generally pessimistic view about the possibility of finding significant uranium deposits in the United States. Commencing in 1953 and extending at least through 1957 significant discoveries of uranium were made to the extent that the problem became one of a threat of uranium becoming a glut on the market. A speculative frenzy took place between 1954 and 1958 which the Commission was powerless to curb despite much rhetoric to the contrary. As the Atomic Energy Commission changed its policies with respect to the purchase of uranium and the prophets of gloom took over between 1960 and 1965, it became virtually impossible to finance uranium exploration. However, a breakthrough in reactor technology that became apparent about 1965 led to renewed activity in uranium company stocks ultimately joined in by some institutional investors seeking exceptional performance that took stocks of many companies to unrealistic highs through 1967 and 1968. With a general slackening in securities markets accompanied by adverse publicity concerning reactor safety, nuclear pollution and the like, investors in uranium stocks took another bath in the late 1969's and through 1970. At every phase the Commission's staff was there to accent the adverse factors and mute the favorable, contributing to the marketplace's inability to view uranium exploration through an objective perspective.

<sup>174</sup> Prior proposals have been in terms of segregation of the dealer and broker function and, if implemented, would have limited the activities of integrated firms. Thus, the Commission in 1936 posed one of the critical issues raised by this article: "A broker who trades for his own account . . . may furnish his customers with investment advice inspired less by any consideration of their needs than by the exigencies of his own position . . ." SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER xvi (1936). See 2 Loss 1215. The foregoing report to Congress was made pursuant to a direction contained in section 11(c) of the Exchange Act as initially adopted. See also Bloomenthal, *supra* note 21, at 220.

<sup>175</sup> Compare the settlement accepted by the Commission under which the underwriting department of a large broker-dealer proposed to insulate confidential information received in the course of preparing an underwriting from other departments and providing for the one-way transmission of information from the research department to the underwriting department, in Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968).

Perhaps, exemption from the segregation requirement should be conditioned upon adequate assurance of a one-way flow of information from the research group to the trading department but otherwise insisting on the insulation of the two departments.<sup>176</sup>

We have seen that utilization of the shell corporation and spin-off corporations is sometimes an attempt to obtain access to a trading market. Specific regulation of access to such markets is badly needed in this area. For starters, the author would suggest a rule making it unlawful for a broker-dealer to request and/or accept any consideration direct or indirect for making a market or placing quotations in the sheets (or other quotation system) for a security. Such a rule is not intended to facilitate access to secondary markets although conceivably it could do so by eliminating the type of motivation that often underlies such decisions today. Segregation of the wholesale and retail phases of the securities industry is likely to further limit access of issuers to a secondary market, as often such access is based upon the need of a particular market-maker for a commodity to merchandise. However, the economic need for such access does not justify practices with such potential for mischief.<sup>177</sup> The problem of limited access to secondary markets also underlies the controlled and dominated market.

It is time that someone commenced thinking about a "fourth market"<sup>178</sup> for the trading in securities of relatively unseasoned com-

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<sup>176</sup> Mr. Robert Trone, head of the research department of Merrill Lynch, Pierce, Fenner & Smith is recently quoted by *The New York Times* as describing his job as one of providing "merchandise" for the firm's customers. That recommendations are influenced by trading information (although purportedly for benign reasons) is demonstrated by his statement: "We must be very careful, due to our size, our market impact, our buying power. We have to avoid recommending companies with a very small floating supply of stock." N.Y. Times, March 5, 1971, at 49, col. 4 & at 57, col. 6.

<sup>177</sup> Thus, the author places himself on the Ferber side in the *Ferber vs. Manne* dispute concerning the role "moral" as distinguished from economic values play in the area of securities regulation. See Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970); Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, *id.* at 621; Manne, *A Rejoinder to Mr. Ferber*, *id.* at 627. An environment that accepts such economic inducement for making a market in a security, contains the seeds of its own destruction by ultimately destroying investor confidence.

<sup>178</sup> Used by the author to distinguish it from the "third market," a term employed to describe trading (generally in large blocks) of listed securities off the exchange (that is, in the over-the-counter market). Presumably, this "fourth market" would have a large number of prospective applicants if there are, in fact, approximately 50,000 securities traded in the over-the-counter market of which only 20,000 (and initially only 3,000) are to be quoted on the NASD's automated quotation system. See note 7 *supra*. As of June 30, 1970, 2,980 issuers had securities listed on a national securities exchange; 3,963 issuers had registered securities under section 12(g) of the Exchange Act and an additional 2,414 issuers were subject to the reporting requirements of section 15(d) of the Exchange Act. 36 SEC ANN. REP. 42 (1970). Compare the Commission's recent proposal that generally it would attempt by means yet to be determined to achieve a single cen-

panies. Access to this market should be conditioned upon making basic information concerning the company available to the marketplace. Any company can pay such price with less serious consequences and ramifications than making a deal with a broker-dealer involving a shell corporation or other questionable practices. Perhaps, we need a subsidized, computerized marketplace administered by a public corporation in which transactions take place only on an agency auction basis much as on an exchange for securities of this type which after appropriate seasoning may graduate to the ordinary markets. The public subsidy necessary to maintain such a market could be substantially less than the costs of policing the present markets in these securities and the costs paid by the duped public.

### CONCLUSION

The federal securities laws contain registration and disclosure requirements; antifraud provisions and anti-manipulation provisions. Some effort is made in this article to see these provisions whole from the perspective of a free competitive securities market. Our ramblings have led to a plea for some long overdue structural changes in over-the-counter securities markets — to wit: (a) establishing ground rules for access to secondary markets; (b) segregating the wholesale and retail phases of the over-the-counter market and (c) establishing a public corporation which would provide a marketplace for unseasoned securities until such securities are ready to graduate to established markets. The need for reform of the securities markets is great and the timing is right as the securities industry is going through a period of reevaluation. Some of the problems discussed in this article are likely to be shunted aside by the self-regulators; nonetheless, they demand attention as they raise fundamental questions of corruption which can over a period of time eat away public confidence in securities markets. The Commission has under consideration some of the problems posed pertaining to market-makers, but unfortunately

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tralized market for all securities open to all qualified persons. Letter dated March 10, 1971 to Congress transmitting the Institutional Investor Study Report. See *BNA SECURITIES REGULATION & LAW REPORT*, Mar. 10, 1971, at 23-25 (extra ed.). Presumably, the author's "fourth market" could be a part of such an undertaking or a pilot program as it recognizes that the reason market-makers exist in the over-the-counter market is the fact that there is no central clearing market at which orders can be matched. The Commission itself has hedged, suggesting that even in a centralized market it may be necessary to preserve a strong dealer function to offset temporary imbalances in the marketplace. *Id.* at 25.

the approach under consideration is largely in terms of disclosure<sup>179</sup> which it has been suggested in this Article is not adequate.

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<sup>179</sup> The Commission is said to be presently engaged in consideration of the advisability of adopting rules "on disclosure of the fact of market making, to delineate the extent and time of disclosure to be required, and whether distinctions should be made as, for instance, between situations where the particular broker-dealer is the sole or dominant market-maker and situations where it is one of a number of market-makers and the price is competitive with quotes of other market-makers . . ." *Chasins v. Smith, Barney & Co.*, CCH FED. SEC. L. REP. ¶ 92,962, at 90,559. The author would suggest that it is time for the Commission to rethink some of the problems that concerned Congress in 1934 as reflected by section 11(e) of the Exchange Act directing the Commission to study this area. See note 175 *supra*. As Professor Loss has noted, the alternative of separating the dealer and brokerage function was not considered in the 1963 *Special Study Report*. 5 Loss 3242.