4-1-1968

Regulation of Over-the-Counter Markups: A Reappraisal of Present Policy

Robert J. Eadington

REGULATION OF OVER-THE-COUNTER MARKUPS: A REAPPRAISAL OF PRESENT POLICY

by Robert J. Eadington

I. The Broker-Dealer in the Over-the-Counter Market

The term Over-the-Counter Market (OTC) encompasses all securities transactions not conducted on an exchange. The distinguishing facet of the OTC market, when compared with an exchange, is that there is no central market place where transactions are consummated. This absence of a central market place makes the participation of broker-dealers, to collect, match, and execute orders, more important in the OTC than in an exchange market. Since all securities markets in the OTC are inter-dealer markets, the public must, by necessity, place a greater degree of reliance on the broker-dealer when trading securities on the OTC market than when trading in issues listed on an exchange.

There are three basic classifications of broker-dealers: wholesale, retail, and the integrated firms. Wholesale dealers stand ready to buy or sell for their own account in transactions with other broker-dealers, who may be acting for themselves or for public customers. Retail firms execute transactions with or for public customers by dealing with wholesale dealers. Integrated firms combine both wholesale and retail activities. That is, they buy and sell both for their own account and with the public.

Markets for securities are made by and between wholesale broker-dealers through communication of quotations representing prices at which they wish to deal for their own account.[1] These market makers react to incoming orders by purchasing and selling through their own accounts. The market makers' purchases and sales may be to other broker-dealers acting for themselves or for public customers. In this way the market makers function analogously to an exchange by providing a place for the collection of buy and sell orders. However, in the OTC market the orders are not matched and executed. Rather, the market maker buys and sells for his own account, depending on the spread between the bid and asked prices to supply him his profit.

The wholesale dealer is thus the key to the OTC market. Because he is buying and selling for his own account, members of the public need not search out other

[1]The absence of a central market makes communications all important in the OTC market. Market makers advertise their markets through an inexpensive voice and printed telgraph network, which connects them with other broker-dealers throughout the country. In addition, there is an extensive use of open-end telephone and teletype to disseminate bid and asked quotations. The "bid" is the price at which the individual broker-dealers are ready to purchase a given security, while the "asked," or "offer," is the price at which they stand ready to sell.

These inter-dealer quotations are not generally available to the public; nor is the public generally informed as to the number and identity of the market makers or the size of their spreads (spread being the difference between their bid and asked quotations). The communications are usually between a market maker and a broker-dealer acting either for himself or a public customer.

public buyers or sellers. The wholesale dealer acts as a channel through which orders may be funneled from broker-dealers whose customers wish to sell and those whose customers wish to buy.

When dealing with the public, the broker-dealer may act either as agent or principal. When the firm acts as agent (broker), it does not take title to the security and is required to reveal its commission to the customer on confirmation. When the firm acts as principal, the transactions are for the account of the firm, and the firm reveals only the net price in its confirmation. Transactions where the firm acts as principal may be of two types. They may be either inventory transactions or the so-called "riskless" transactions. This latter transaction occurs when the broker-dealer, after having received a purchase order, purchases for his own account from a wholesale dealer and immediately resells the security to his customer at a marked-up price, thus avoiding any risk of ownership.[2] The price at which stock is sold to the public customer is the retail as opposed to the wholesale (inter-dealer) price.

The integrated firm carries on both wholesale and retail activities. Its wholesale activities may be primarily an adjunct to its retail activities.[3] The integrated firm may use its trading department to accumulate inventories for sale to public customers through its retail department. The firm may be a market maker, or even the sole or dominant market maker, in a particular security.

The *Report of the Special Study of Securities Markets*[4] found that principal transactions constitute a high percentage of public purchases of OTC securities. A random sample taken in January, 1962, disclosed that 38.7% of the number of shares purchased by public customers over-the-counter, and 53.6% of the value of such shares, were purchased through firms acting as principal in the transactions.[5] The markups on such principal transactions, which are undisclosed, are usually higher than agency commissions, especially in "riskless" transactions involving retail dealers.[6] In the integrated firm, however, the markup on an inventory transaction may often be less because of the dealer's "position."

The ability of a broker-dealer to act as principal when dealing with public customers, combined with the public's relative inability to determine true market price, has been, and remains, an area with high fraud potential. While recent National Association of Securities Dealers (NASD)[7] sponsored publication of

---

[2]Riskless transactions constitute approximately 24% of all individuals' purchase transactions (both principal and agency) by share volume. REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H. R. DOC. NO. 95, Pt. 2, 88th Cong., 1st Sess., p. 614 (1963) [hereinafter referred to as SPECIAL STUDY].

[3]SPECIAL STUDY, Pt. 2 at 578.

[4]H. R. DOC. NO. 95, 88th Cong., 1st Sess. (1963). The SPECIAL STUDY is a multi-volume report on all aspects of the American securities industry.

[5]SPECIAL STUDY, Pt. 2 at 612.

[6]*Id.* at 639.

[7]The NASD is a regulatory organization formed under the auspices of the 1939 Maloney Amendment to the Securities Exchange Act of 1934. Membership in the association is comprised of over 80% of all registered broker-dealers in the nation. The NASD, under authority

wholesale prices has done much to alleviate the problem by making quotations on many OTC traded securities available to the public, quotations for a large proportion of such securities are still known only to insiders of the industry.[8] The inability of the public customer to ascertain what percentage of the price charged is due to the dealer's markup has allowed some broker-dealers to take unfair advantage of their position. The following examples illustrate the problem.

A asks his broker-dealer to purchase 100 shares of common in *XYZ* Corporation, whose stock is traded only over-the-counter. *A's* dealer inquires of wholesalers and finds the stock presently quoted at 59-60½. If he acts as agent, he will purchase the 100 shares at a cost of $6,050. Adding a $45 commission,[9] which is disclosed on confirmation, the bill to *A* will be $6,095. However, the result could be quite different if *A's* dealer decided to act as principal. Since the dealer is not required to disclose the amount of his markup, he may buy for his own account at 60½ and immediately resell to *A* at 62, 63, or more. Thus, the additional cost to *A*, if his dealer executes at 63, will be $205 merely because of the form of the transaction. *A* may never become aware of the additional cost; while there were no extra services rendered, the dealer's actions were perfectly legitimate under present law.

For a further example, let us assume that *ABC* is an integrated firm whose retail department has just received an order for 200 shares of *QT* Corporation common stock. *ABC's* wholesale department has a position in *QT's* securities and is the principal market maker for this stock. *ABC* is not negotiating; its quotes are 9½ bid, 10 asked. If a retail dealer had placed the order, purchased at 10, and immediately resold to a public customer at 10½, his actions would have been perfectly legal. The cost to the customer would have been $2,100. However, if the integrated firm were to execute a sale from its inventory to a public customer at 10, it might very well be violating the law. Cost to the customer would be only $2,000, yet, his broker may have violated the NASD's markup policy.

II. Price Unreasonably Related to Prevailing Market Price

The NASD's markup policy was adopted in 1943 in response to a proposed rule of the Commission which would have required full disclosure of inside bid and asked prices by broker-dealers before consummation of any transaction. The markup policy is an interpretation of the basic Rule of Fair Practice that members "shall observe high standards of commercial honor and just and equitable principles of trade."[10] The policy is known as the "5% policy" through the NASD's initial interpretation that markups should not exceed five percent.

---

of section 15a of the Securities Exchange Act of 1934, promulgates rules and regulations designed to maintain a high standard of integrity within the industry.

[8]In addition to private communications, quotations are submitted to the National Quotation Bureau (NQB), a private corporation. These quotations are then compiled and made available to subscribing members of the industry the following day. The NQB's "pink sheets" are not generally available to the public.

[9]This is the standard New York Stock Exchange commission on such a round lot transaction.

[10]NASD Manual ¶ 2151 (Reprint 1967).

The present NASD Board of Governors' interpretation of Rules of Fair Practice, section 4,[11] states:

1) the "5% policy" is a guide—not a rule;
2) a member may not justify markups on the basis of expenses which are excessive;
3) in absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security;
4) a determination of the fairness of markups must be based on a consideration of all the relevant factors, of which the percentage markup is only one.[12]

While five percent itself could be an excessive markup, a somewhat higher percentage may be justified when dealing in stocks selling for less than ten dollars, according to the present interpretation.[13]

Concern here is primarily with the application of the policy to principal transactions, and with the broad scope of that application. The "5% policy" applies to inventory as well as riskless transactions, to sales of active as well as inactive securities, and to integrated firms making markets as well as to firms engaged solely in retail activities. This breadth of application gives rise to serious questions as to the fairness of the policy.

NASD District Conduct Committees initially enforce the Rules of Fair Practice. These committees conduct disciplinary proceedings to investigate possible violations of those rules, render decisions, and impose penalties when appropriate. The SEC receives a copy of every such decision and may review any disciplinary action taken. Upon a District Committee's finding of a violation of the "5% policy," the Committee may censure, fine up to one thousand dollars ($1,000), suspend, and/or expel any member or revoke the registration of any person associated with a member.[14] The practical effect of suspension, expulsion, or revocation is that the NASD's rules require that a member shall deal with non-member broker-dealers only at the same prices and on the same terms as such member accords to the general public.[15] Thus, a broker-dealer whose membership has been suspended or revoked cannot obtain underwriting discounts or commissions as a participant in distributions by NASD members. Since over 80% of the industry is registered with the NASD, this can be a heavy penalty.

While the SEC does not have a rule directly corresponding with the NASD's "5% policy," limited regulation of the conduct of broker-dealers in the over-the-counter markets has been achieved by reliance on the fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.[16] On the basis of these provisions, the Commission has developed a number of fraud concepts

---

[11] *Id.* ¶ 2154.

[12] *Id.*

[13] *Id.*

[14] *Id.* ¶ 2301.

[15] *Id.* ¶ 2175.

[16] These fraud provisions comprise § 17(a) of the Securities Act and § 15(c)(1) of the Exchange Act. 15 U.S.C. §§ 77(q), 78(o)(c)(1) (1964). Under § 15(c)(2) of the Exchange Act, the Commission also has power to prevent acts of fraud, deceit, or manipulation of over-the-counter markets. 15 U.S.C. § 78(o)(c)(2) (1964).

particularly applicable to the over-the-counter markets, and through the use of these concepts, the Commission has articulated standards of conduct concerning the relations of broker-dealers to their public customers.[17]

As early as 1943, in *Charles Hughes & Co. v. S.E.C.*,[18] the SEC began regulating the practice of excessive markups. Regulation has been based upon the "shingle" theory developed in the *Hughes* case. This theory imposes upon a broker-dealer doing business with the public a duty to deal "fairly and in accordance with the standards of the profession."[19] This duty arises out of an implied representation in holding one's self out as a professional. It is based on the premise expressed in *Hughes* that "[t]he essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do."[20] It has been held that charging a price unreasonably related to the prevailing market price, without disclosing that fact, is a breach of the implied representation of fair dealing and can lead to penalties up to, and including, cancellation of registration with the SEC as a broker-dealer.[21]

III. PROOF OF VIOLATIONS

The major portion of regulation of unfair markups is still accomplished by the NASD. This has, in recent years, caused charges of arbitrariness due to the wide and indifferent application of the "5% policy." The Special Study commented that one of the more difficult problems at present is judging the fairness of markups where a firm has a position and where it has not.[22] Present interpretation of the "5% policy" to a great extent disregards this basic distinction inherent in firms which may be dealing with public customers. As the *Report* pointed out:

> It is important to recognize the difference between a broker-dealer executing as principal in a riskless transaction and the market maker who also acts as a principal. While both may execute on a principal basis, the function of the former is limited to execution of the order and in essence performing the function of a broker for which his undisclosed markup is a service charge. The market maker, on the other hand, in addition to executing the transaction, provides marketability by assuming the risk of taking positions.[23]

These are basic economic differences which must be considered in determining the fairness of markup for the retail and the integrated firms.

A. *The Retail Dealer*

While the public customer can usually decide whether his broker-dealer will act as agent or principal, in actual practice the firm may unilaterally decide in what

---

17 SPECIAL STUDY, Pt. 2 at 653.

18 139 F.2d 434 (2d Cir. 1943). *See also* Duker & Duker, 6 S.E.C. 386 (1939).

19 SPECIAL STUDY, Pt. 2 at 653.

20 Charles Hughes, 139 F.2d 434, 437 (2d Cir. 1943).

21 Duker & Duker, 6 S.E.C. 386 (1939); Jansen and Co., 6 S.E.C. 391 (1939).

22 SPECIAL STUDY, Pt. 2 at 648. A firm has a position in a security when it has an inventory in that security; it is at "risk."

23 SPECIAL STUDY, Pt. 2 at 611.

capacity it will act when dealing with an unsophisticated customer.[24] The retail dealer who is not at risk has little justification for a large markup. In the retail firm's riskless transaction, the dealer's contemporaneous cost is usually the base for computing markup.[25] The contemporaneous cost in the normal riskless transaction will be the inside offer of the wholesale dealer from whom the original purchase was made. In determining reasonableness of the price, the Commission has said:

> . . . the price paid for a security on the same day it is sold to his customer is the best evidence of market price for purposes of determining the amount of the mark-up [spread] charged the customer.[26]

There are, however, admitted exceptions to this rule.[27]

In determining the fairness of the spread, the NASD may take into consideration the price range of the securities and any unusual expenses incurred by the dealer. However, the interpretation of the Board of Governors concerning stocks selling for less than ten dollars has been given little or no weight.[28] As to unusual expenses, those of shopping around, solicitation, research, and other services, the NASD has stated that these may be taken into account in determining markup. It has been held that excessive costs,[29] or the mere fact that a dealer is entitled to a profit,[30] cannot justify excessive expenses. While such is the present interpretation of the "5% policy," the NASD has "not attempted to spell out in detail the amounts and kinds of costs that might be considered excessive."[31]

The Special Study strongly recommended that a dealer who neither is a primary market maker nor has a bona fide inventory position be required to execute retail transactions on an agency basis.[32] This recommendation was founded upon the Study's conclusion that the riskless transaction, without disclosure of markup or commission, is inherently susceptible to abuse. It is submitted that the riskless transaction could be abrogated by extension of a concept already developed by the SEC.

The Commission has imposed special obligations upon broker-dealers in situa-

[24] *Id.*, Pt. 2 at 612.

[25] Contemporaneous cost is the price at which the dealer has bought such shares on the day of the sale to a customer, or if none, the day before or the day after such sale.

[26] Managed Investment Programs, 37 S.E.C. 783, 786 (1957). *See also* Barnett v. United States, 319 F.2d 340 (8th Cir. 1963); Samuel Franklin & Co. v. S.E.C., 290 F.2d 719 (9th Cir. 1961).

[27] *See* SPECIAL STUDY, Pt. 2 at 648, n. 298. The *Report* stated that if the dealer has a firm commitment to take down shares at a substantial concession, then the asked price quotations in the sheets may be taken as indicative of current market price rather than contemporaneous cost.

[28] Kenneth B. Stucker Investment Securities, Securities Exchange Act Release No. 7823 (Feb. 15, 1966).

[29] *Id.* In this release, it was stated that excessive expenses in effecting sales—for company studies, attendance of company's stockholders' meeting, political activity, recording transactions and other expenditures on behalf of the public and the company—cannot justify an excessive markup.

[30] Boren & Co., Securities Exchange Act Release No. 6367 (Sept. 19, 1960).

[31] SPECIAL STUDY, Pt. 2 at 648.

[32] *Id.*, Pt. 2 at 676.

tions where a relationship of trust and confidence existed between the dealer and his customer. In such a situation, the broker-dealer is considered a fiduciary and is required to make complete disclosure of his adverse interest in any transaction. While such a broker may nominally act as principal, the Commission imposes the obligations of an agent because of the established relationship.[33] In *Oxford Co., Inc.*,[34] a case involving two elderly customers, the Commission held the dealer to the obligations of an agent stating:

> A firm which makes a purchase to fill an order solicited by it when it knew it did not have the securities on hand is making that purchase for its customers—in fact and within the meaning of the act [sec. 17(a) of the Securities Act of 1933, sec. 15(c)(1) of the Exchange Act of 1934]. Such transaction is, therefore, a brokerage transaction under the statute, *and it is a brokerage transaction apart from the fact that the particular customer may be . . . especially reliant on the firm* by reason of particular trust, confidence, or infirmity. Under these circumstances the firm must fulfill the obligations of brokerage in the transaction: among other things . . . to refrain from taking secret profits, to make the best deal for the customer at the best price obtainable, and to confirm as agent making specific disclosure of the amount of remuneration.[35] (emphasis supplied).

This case imposed the obligations of an agent, including disclosure of markup, upon a dealer who had engaged in riskless transactions. It has, in later cases, been limited to situations of particular trust, confidence, or infirmity.[36] The language, however, is broad enough to apply to transactions apart from such special circumstances.

The Commission could, through an extension of the *Oxford* doctrine, put an end to the abuses of the riskless transaction. Section 17(a) of the Securities Act of 1933 makes it unlawful for any person in the sale of securities in interstate commerce or by use of the mails

> (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of . . . any omission to state a material fact . . . or (3) to engage in any transaction . . . which operates or would operate as a fraud or deceit upon the purchaser.[37]

Rule X-15C-2, promulgated under section 15(c)(1) of the Securities Exchange Act,[38] states, in similar fashion, rules to the same effect. Under these authorities, the *Oxford* doctrine could be extended to all broker-dealers who are neither market makers nor at risk by having an inventory position. This would require the broker to fulfill the obligations of his agency though acting nominally as principal in executing a riskless transaction.

Both the NASD and the SEC, however, have declined to promulgate rules disallowing retail broker-dealers to act as principal in public transactions. Instead, since the report of the Special Study, they have both worked for stricter application

---

[33] Arleen W. Hughes, 27 S.E.C. 629 (1948), *aff'd sub. nom.* Hughes v. S.E.C., 174 F.2d 969 (D.C. Cir. 1949).

[34] 21 S.E.C. 681 (1946).

[35] *Id.* at 692.

[36] *See* Investment Registry of America, 21 S.E.C. 745 (1946); Norris & Hirshberg, Inc., 21 S.E.C. 865 (1946), *aff'd*, 177 F.2d 228 (1948).

[37] 15 U.S.C. § 77(q)(a) (1964).

[38] 15 U.S.C. § 78(o)(b), (c)(1) (1964).

of the "5% policy" as now interpreted.[39] While it does not get to the root of the problem, such an approach can prevent most, if not all, of the more serious abuses pointed out by the *Report.* It is in light of this policy determination that extra attention must be directed toward the treatment of integrated firms.

B. *The Integrated Firm at Risk When There Exists an Independent Market*

It is important for purposes of analysis to make a distinction between methods of computing markups. The courts have made such a distinction between "spread" and markup. In *S.E.C. v. Seaboard Securities Corporation,*[40] spread was defined as the difference between the dealer's contemporaneous cost and the price charged the customer. Markup was defined as the increment of the price charged to the customer over the current market price. Thus, for a strictly retail dealer, who purchased a security from a wholesale dealer at market price, spread and markup would be the same.[41] Such is not necessarily the result when a market maker is involved. While a distinction has been made between spread and markup, they are too often treated as synonymous in actual litigation. This has led to confusion in determining a proper base for computing markup when an integrated firm at risk is involved. Should the base be contemporaneous cost, or should it be a representative asked price of another wholesale dealer appearing in the sheets?[42] If contemporaneous cost is the base, it will usually be the dealer's own inside bid. In many low priced securities, however, the difference between the dealer's bid and asked prices will exceed five percent because of the risk involved in maintaining an inventory. If the dealer's inside bid is used as a base for determining fairness of markup, the result will be to force the dealer to sell to public customers at a price less than what he is asking from other broker-dealers. This, obviously, would destroy his market and with it the liquidity his trading has given the security. On the other hand, to use a representative asked price found in the pink sheets as a base would allow a spread considerably in excess of five percent.

An example was given earlier of transactions in a security with a market of 9½ bid, 10 asked. Assuming this is a stable market with several firms participating, it can be seen that a sale at 10½ to a public customer by an integrated firm from

[39] *See* Rosenbloom, Securities Exchange Act Release No. 7762 (1965).

[40] CCH FED. SEC. L. REP., ¶ 91697 (1966).

[41] A retail dealer who purchased at a price above the prevailing market would still be restricted to a five percent "markup" under the NASD's present policy. Thus, he may not use contemporaneous cost as a base to compute his markup. This could place the dealer in the position of being unable to ascertain what base he may use, unless, as is discussed later, he may use the bid price of a representative market as that base.

[42] For purposes of the following discussion, certain assumptions must be made. The discussion is concerned with the integrated firm at risk when there exists a market independent of that being made by the firm in question. Thus, it must be assumed that there are several firms making quotes on the given security. Also, it must be assumed in light of the findings of the Study that inter-dealer negotation is not prevalent and that a dealer is usually able to execute transactions at his bid and asked prices. The bid and asked prices of the competing dealers should be closely related. A representative asked price, therefore, would be one which reflected the general market for a given security.

inventory would, using contemporaneous cost as a base, violate the NASD's "5% policy." At the same time, a "riskless" sale at 10½ by a retail dealer, who has not taken the risk of maintaining a position, involves a legal markup of only five percent.

The Study pointed out that there appeared to be doubts among NASD officials as to the fairness of using contemporaneous cost as a base for computing markup where an integrated firm was at risk.[43] A change in emphasis, however, has not been adopted by either the Commission or the NASD examiners.[44] While the most recent NASD interpretation of its markup policy states that in a "transaction in which a member sells a security to a customer from inventory . . . the amount of the markup should be determined on the basis of the markup over the bona fide representative current market,"[45] the cases still hold that contemporaneous cost is the best indication of that market.[46] The sheets are used as an indication of the prevailing market only when there are no purchases on which to compute contemporaneous cost[47] or when the dealers' costs are out of proportion to the market represented in the sheets.[48] The Commission, nevertheless, has expressly refused to accept published quotations in lieu of contemporaneous cost as the best evidence of prevailing market price.[49]

Notwithstanding the present interpretation, most integrated firms base their markup in retail transactions on their inside offer rather than their inside bid.[50] The reason for computing markup in this manner was stated to the Special Study by the then chairman of the Board of Governors of the NASD:

> As I look at a transaction involving both a retail sale and a position, I think of it, in effect, as reflecting two functions. One is the retail function. For this I think the dealer is entitled to a profit equivalent to the profit he would derive if he were not in position. . . . [A]ny profit that he earns as a result of being in position, and at risk, is a separate profit, to which he is entitled by virtue of his willingness to assume the risk.[51]

It is submitted that the truth of the above statement should be recognized by the NASD and SEC. In the previous example, this would allow the integrated firm to sell to the public customer at 10½, representing a five percent markup and a

---

43SPECIAL STUDY, Pt. 2 at 649-51.

44Use of contemporaneous cost is still the appropriate base upon which to compute markups in retail transactions, absent countervailing evidence; *see* Barnett v. United States, 319 F.2d 340 (8th Cir. 1963); Samuel B. Franklin & Co. v. S.E.C., 290 F.2d 719 (9th Cir. 1961); Maryland Securities Co., Inc., 40 S.E.C. 443 (1960).

45NASD Manual ¶ 2154 (Reprint 1967).

46Naftalin & Co., Inc., 41 S.E.C. 823 (1964). The above case so held after a discussion of the findings of the *Report.*

47Merritt, Vickers, Inc. v. S.E.C., 353 F.2d 293 (2d Cir. 1965); Matter of Cortland Investing Corp., Securities Exchange Act Release No. 7682 (Aug. 24, 1965).

48Ross Securities Inc., 40 S.E.C. 1064 (1962).

49Naftalin & Co., 41 S.E.C. 823 (1964); Boren & Co., 40 S.E.C. 133 (1960). In *Naftalin,* however, the security involved was one of limited activity and there was evidence that negotiations were prevalent. In light of these circumstances, the commission's opinion does not necessarily reject primary use of the sheets under a different factual situation.

50SPECIAL STUDY, Pt. 2 at 649.

51*Id.,* Pt. 2 at 649.

price equal to that charged by a retail dealer.[52]

Use of the asked price, however, has been criticized especially when dealing with low priced securities due to the element of negotiation in OTC transactions. The asked price may not be the price at which the dealer is actually transacting business. Assuming for the present, however, that there is a market independent of that being made by the individual firm, the solution should not be difficult.

In *Matter of Shearson, Hammill & Co.*,[53] the NASD, using contemporaneous cost as a base, had found violations of its markup policy. The member argued that by using the lowest inside asked prices reported in the sheets as a base, the markups did not exceed five percent. The Commission, however, used as a base the highest actual price at which petitioner made a bona fide sale to another broker-dealer (the inside asked price) on the dates of the sales to public customers. When there were no sales to other broker-dealers, the Commission used the lower of the petitioner's highest inside sales price on the closest inside sale or the lowest inside asked price reported in the sheets on the day of sale.[54]

The above means of computing markups should be the predominant and accepted method when dealing with a firm at risk. Using purchase price (contemporaneous cost) when dealing with a retail firm may be the best indication of prevailing market price. Nevertheless, when dealing with a firm making a market, it is submitted that the price at which that firm makes sales to other broker-dealers is the true market price of that security, at least where there is more than one market maker in that security.[55] Using the price at which the dealer makes sales to other broker-dealers will also equalize the integrated firm's treatment, in regard to public sales, with that of the retail firm. Since, as indicated by the Study, the dealer can usually transact sales at his inside asked quote, this should be, if bona fide,[56] the base for computing markup. When the dealer has not made contemporaneous sales to other broker-dealers, then the truest indication of the prevailing market could be ascertained by using the lower of either the lowest representative asked quotation in the sheets[57] or the highest inside

---

[52]As shall be seen, however, it actually is the price at which inter-dealer sales are executed, rather than the dealer's offer, that should be used as a base to compute markup.

[53]Securities Exchange Act Release No. 7743 (Nov. 12, 1965).

[54]The Commission felt that the average daily cost (contemporaneous cost) was a difficult base because a broker-dealer could not determine a fair markup until the end of the day, and, if the market declined after the order was executed, the markup could retroactively become excessive. However, the Commission further stated that the registrant's asked price was not the best base where the evidence showed there were actual and substantial sales to dealers on the days in question.

[55]The problem presented where there is no independent market will be dealt with *infra.*

[56]Since the existence of an independent market presupposes fairly active trading, an isolated sale at a price out of proportion to other inter-dealer sales could be shown not to be a bona fide sale for the purpose of computing markup. Likewise, sales which, through collusion of dealers, are executed for the purpose of obtaining a higher base could not be considered bona fide.

[57]S.E.C. Regulation 15 c 2-7, prohibiting fictitious quotations, has made the sheets a more reliable indicator of market prices, and it is suggested that this should give rise to

sale price by the dealer on the closest date before or after the transaction in question.

To illustrate, assume that *ABC* firm is making a market in *QT* Corporation at 9½ bid, 10 asked. On Monday, *ABC* sells 300 shares of *QT* to dealer *X*, a retailer, at ten dollars a share. For sales to public customers on Monday, *ABC* should be allowed to compute markups from a base of 10. Thus, for sales to public customers on Monday, *ABC* and X would be computing markup from the same base.

On Tuesday, assume *ABC* does not execute any sales to other dealers. However, eight firms have entered quotes in the sheets. One firm is quoting 9⅜-9⅞; five, including *ABC*, are at 9½-10, two at 9⅝-10⅛, and one at 9¾-10¼. *ABC* would know it could compute markups for public sales at 10. This is ascertained by using the lower of either the inside sales price on Monday or the lowest representative asked quotation in the sheets on Tuesday. Here, both are ten dollars.

On Wednesday, *ABC* again fails to execute any inter-dealer sales. The sheets, however, reflect a slight decline in the overall market for the security. Six of the eight firms entering quotes Wednesday are at 9⅜-9⅞. *ABC* is still quoting 9½-10, while one firm is quoting 9⅝-10⅛. On Wednesday, *ABC* must compute its markups from a base of 9⅞, that being the lower of either the highest inter-dealer sales price received by *ABC* on the closest day, Monday, or the lowest representative asked price in the sheets Wednesday. The decline in the market has been accounted for in *ABC's* new base.

When one takes into account the risk assumed by a firm holding a position, this method would result in the most equitable computation of markups as long as there were markets independent of that being made by the dealer involved. Possible abuse of such a method could be prevented by the implementation of a maximum allowable spread.[58]

C. *The Integrated Firm at Risk When There Exists No Independent Market*

A difficult area of interpretation of the "5% policy," and one which evoked much comment from the Study,[59] is in computing markups on transactions by integrated firms trading in securities for which there is no market other than that being made by the participating broker-dealer. There are many securities traded in the OTC markets that have very limited activity and are handled by only one or two dealers.[60] The risks involved in maintaining a position in a security which is

---

greater use of the sheets by the NASD and the Commission.

[58]Discussed *infra.*

[59]SPECIAL STUDY, Pt. 2 at 651-53, 676.

[60]The *Report* in a random selection of 300 stocks in the sheets over a two week period found that for 91 securities out of the 300 (30%), at most only one dealer indicated an interest on any particular day, and that for 139 securities (46%), at most only two dealers indicated such an interest. SPECIAL STUDY, Pt. 2 at 587.

inactive may require dealer spreads considerably in excess of five percent.[61] If the "5% policy" is strictly applied, as is sometimes the case,[62] the firm may be required to sell to public customers at a price less than the price at which it stands ready to sell to other broker-dealers. Under these circumstances it may be impossible for the dealer to maintain a market in the security. It has been argued, however, that since the market is a non-competitive one, the dealer's own inside asked price is not a satisfactory guide as it may be wholely unrelated to the market he is actually making.[63]

The NASD has therefore used contemporaneous cost as the base in enforcing its markup policy where there is no independent market. It has declined to allow member dealers to use inside quotes which they may have unilaterally established. The problem here is that, if uniformly enforced, the "5% policy" could tend to reduce the availability of markets on low priced securities for which there is limited dealer interest. The alternative, however, need not allow the use of an artificial base.

It is suggested that a method somewhat similar to that mentioned above, pertaining to dealers at risk but with an independent market, be utilized. That is, contemporaneous cost to the integrated firm is not the best indication of true market value. Rather, the markup should be computed from a base of the price at which bona fide sales are made to other broker-dealers. The inside offer is not satisfactory because it is often subject to negotiation. Using the sales price to other dealers would take into consideration the element of negotiation and bring the integrated firm into a position on a par with the retail firm. Since the markets here are by definition inactive, the fact that several days may elapse between transactions should not, absent evidence to the contrary,[64] destroy the value of inside sales as indicative of market value. The possibility of abuse to which such an interpretation of the "5% policy" might give rise would best be handled by the SEC under the anti-fraud provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934[65] and by the application of a "Spread Policy" by the NASD.

---

[61]This is especially true in respect to low priced securities. In maintaining an inventory, a dealer gives liquidity to the security, which is a great benefit to public holders. However, due to the limited demand (hence inactivity) for the security, the risk in maintaining an inventory is quite high. A relatively slight decrease in demand for the security can cause a high percentage drop in price.

[62]*See* In the Matter of Strathmore Securities, Securities Exchange Act Release No. 7150 (Sept. 30, 1963). There, the dealer's inside bid and asked was 1⅝-1⅞. Using contemporaneous costs, the NASD and the Commission found a violation of the "5% policy" when petitioner made public sales at its inside asked price.

[63]This could be the case if the firm was engaged in a retail sales campaign and was using its own inside prices as the basis of all retail sales.

[64]Such evidence to the contrary can range from a recent decline in the earnings of the corporation intimating a drop in the value of its securities to a showing that the most recent inter-dealer sale was made at an inflated price due to collusion between the dealers.

[65]§ 17(a) of the Securities Act of 1933 and § 15(c)(1) of the Securities Exchange Act of 1934. 15 U.S.C. §§ 77(q), 78(o)(c)(1) (1964).

When there is no market independent of that being made by an integrated firm, the ultimate safeguard for the public customer, competition among market makers, is lacking. The firm may create the appearance of an active and broad trading market, while, in fact, the withdrawal of its support could cause the market to evaporate. By actively soliciting retail purchasers the firm may dispose of a position and, when it has done so and stopped trading, leave the public customers without a market to dispose of their securities. The Commission has attempted to reach such abuse under the fraud provisions of the Exchange Act. The theory is based on the premise that it is a fraud for a dealer to sell without disclosing that he has dominated or controlled the market.[66] The Commission first finds that there is an implied representation that the price quoted by a dealer is the market price.[67] Then,

> [W]hen a security is sold "at the market," the failure to disclose to purchasers that the market price has been artificially inflated by the seller's manipulation is an omission to state a material fact and constitutes a fraud on the purchaser.[68]

It was under such a theory that rule 15(c)(1)-(8) was adopted.[69] The rule precludes a dealer from representing, in a primary or secondary distribution, that the shares are being offered "at the market," unless such dealer has reasonable grounds to believe that a market for the security exists independent of the dealer or an associate or affiliate of the dealer. Similar principles could be applied to the OTC generally, requiring disclosure by the dealer that there is no market other than the one he is making. Such an approach would eliminate the danger pointed out by the Commission in *S.T. Jackson & Co.*,[70] where it noted:

> [The] purchasers did not know that they were being subjected to the hazards inherent in a situation where the withdrawal of support by the persons dominating the market would mean the closing of the only available forum for trading in such securities. . . .[71]

A requirement that the sole or dominant market maker in a security disclose his control of that market would give the public investor a much needed protection when dealing in over-the-counter securities. However, unlike a strict application of a percentage markup policy, it would also allow the dealer to continue making a market in inactive securities requiring a relatively broad spread. The Commission should, under section 15(c)(1) of the Exchange Act, extend the requirement of disclosure of control where there is no independent market. Failure by the dealer to disclose such control would make misleading the implied representation that the prices charged were determined in a free and competitive market.[72]

---

[66] *See* Barrett & Co., 9 S.E.C. 319 (1941); Sterling Securities Co., Securities Exchange Act Release No. § 6100 (Nov. 2, 1959).

[67] S.E.C. v. Otis & Co., 18 F. Supp. 100 (N.D. Ohio, 1936); R. L. Emacio & Co., 35 S.E.C. 191 (1953).

[68] Barrett & Co., 9 S.E.C. 319, 329 (1941).

[69] Com. Rul. 17 C.F.R. § 240, 15 c 1-8.

[70] 36 S.E.C. 631 (1950).

[71] *Id.* at 656.

[72] While such a requirement would not guarantee the fairness of markups, it does forewarn public purchasers of their possibility. *See* H. S. Bloomenthal *The Case of the Subtle Motive and the Delicate Art—Control and Domination in Over-the-Counter Markets*, 1960 DUKE L.J. 196.

D. *Proposed Spread Policy*

In the area of self-regulation, the *Report* strongly recommended substantial clarification and strengthening of the NASD's markup policy. In particular, it stated:

> [The] integrated broker-dealer's obligation and standards of retail pricing in relation to its contemporaneous cost or its current interdealer quotations, especially in the case of securities for which there is no independent market, should be defined, by the Commission and/or the NASD, more clearly and positively than has been done in the interpretations or administration of the present markup policy.[73]

The following proposal would, hopefully, meet these recommendations made by the *Report.*

It is essential that, in dealing with integrated firms making markets, the NASD recognize the distinction previously noted between "markup" and "spread." The NASD in its interpretation of its markup policy should define markup as the increment of the price charged to the customer over the current market price. For the retail dealer this would mean the continued use of contemporaneous cost as indicative of the prevailing market price. The integrated firm with a position, however, should generally be allowed in computing its markup to use its inside asked price as the base. As pointed out above, this would give a truer indication of the current market and, under a five percent markup policy, would equalize the integrated and retail firms' public sales price.

The NASD should also adopt a definite policy on allowable spread to the integrated dealer, spread being defined as the difference between the dealer's contemporaneous cost and the price charged a public customer. Extensive research in respect to the activity of integrated firms throughout the nation would allow the NASD to determine a reasonable percentage, or percentages, which a dealer's "spread" could not exceed irrespective of current market price.[74] Application of such a rule to the integrated firm, especially when dealing in a security without an independent market, would prevent abuse of the suggested modification of the "markup" policy.

Enforcement of a "spread policy" would prevent the broker-dealer from padding prices in order to increase his markup. It would likewise discourage the incurring of excessive expenses and of undue risks in the belief that contemporaneous cost would no longer be used in computing the fairness of the sales price. Thus, while the firm's inter-dealer sales price would be used as a base for computing its markup, its contemporaneous cost would also be used to determine the fairness of its spread. Should the firm's spread be out of proportion to that of broker-dealers engaged in similar activities, then, the firm would be forced to decrease its markup sufficiently to bring its spread back within an acceptable margin.

The implementation of a "spread policy" in conjunction with a modified "5% policy" would add much needed flexibility to the present system, while at the

---

[73]SPECIAL STUDY, Pt. 2 at 677.

[74]Perhaps a survey similar to that conducted prior to the adpotion of the present "5% policy" would accomplish this purpose.

same time preventing abuse of the markup policy. Further, the added flexibility would permit a more vigorous, and at the same time more equitable, enforcement of the Rules of Fair Practice as promulgated by the NASD.

IV. Conclusion

Today's OTC market demands both greater flexibility for broker-dealers, so that they may properly handle the ever increasing number of issues traded, and stricter regulation of broker-dealers to protect the unwary public customer from the many possibilities of fraud which exist in that market. While these needs may seem contradictory, it is submitted that both may be accomplished by a comprehensive re-evaluation of present regulation, and the implementation and extension of already existing anti-fraud concepts. It has been the purpose of this comment to suggest methods whereby both objectives may be accomplished.

As previously discussed, it is necessary that a basic distinction be recognized between a dealer executing retail transactions who is neither at risk nor has a bona fide inventory position and the integrated firm that does. When such a distinction is made, the following results should follow:

A. The Retail Dealer Firm.

1. The riskless transaction is inherently subject to abuse. An extension of what has here been termed the *Oxford* doctrine could, for all practical purposes, put an end to retail transactions taking this form. While acting nominally as principal, the dealer would be held to the obligations of an agent.
2. If such regulation is found to be undesirable, then the present "5% policy" should be strictly enforced using contemporaneous cost as a base.

B. The Integrated Firm at risk when there exists a market independent of that being made by the firm.

1. It is suggested that the NASD markup policy acknowledge the valuable function which these market makers serve. The present "5% policy" should continue to be enforced, but methods of determining the prevailing market price should be brought more in line with the economic realities of the OTC.
2. To prevent abuse by dealers of a more liberal application of the "5% policy," a maximum spread policy should be promulgated by the NASD.

C. The Integrated Firm at risk when there exists no market independent of that which it is making.

1. The NASD should apply the present "5% policy" in a manner similar to that suggested for the firm when there is an independent market.
2. Likewise, a maximum spread policy should be implemented.
3. Finally, for the protection of the public customer, the Commission should make it mandatory that a sole or dominant market maker disclose that fact before execution of retail orders.

The above suggestions would both give the trader more freedom in his activities and supply greater protection to the investing public.