THE CASE OF THE SUBTLE MOTIVE AND THE DELICATE ART–CONTROL AND DOMINATION IN OVER-THE-COUNTER SECURITIES MARKETS

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I

THE OVER-THE-COUNTER MARKET

THE FOUR teletype machines click out their monotonous symphony of sounds. The ticker tape rolls off the private wires connecting this office with branch offices and corresponding firms throughout the country. Lights flash on the six direct lines to local dealers. The floor is strewn with tape and other debris, and smoke fills the air-conditioned atmosphere. The din of talk and sound is overwhelming as the four assistant traders and the chief trader carry on their vocation. This is the trading room of the *X* Company, a moderate-sized securities dealer. Similar activity of lesser and greater proportions is going on simultaneously in the trading rooms of securities firms throughout the country.

The chief trader is busy marking off his tally sheet, keeping track of his firm's position in twenty-five or more securities. Now a call from a customer's man over a direct line: "Market in *ABC* Company, have buyer for 1,000 shares."

"Minute, please. We don't do it."

A flick of the switch on a direct line to a local dealer: "Market in *ABC*."

Reply: "Inside market eighteen cents bid, twenty cents ask."

"How long may have ask price on 10,000 share firm?"

"Thirty minutes."

Flick of another switch and back to the customer's man. "Have

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10,000 share firm at twenty cents for thirty minutes. Offer to customer at twenty-five cents."[1]

The teletype is demanding a reply: "*B-D* Securities Company calling, your market, please, in *XYZ* Company stock."

"One dollar ask and $1.25 bid," the trader types back.

"Size, please?"

"Market good for 5,000 shares either way."

"We have bought 1,000 shares from you at $1.25."

"We have sold you 1,000 shares at $1.25."

A quick notation of the order, which is then time stamped.

A lull in the trading activity occurs, and the chief trader hands an assistant a list of five securities traded by the *X* Company and instructs him as follows: "Check other markets in these securities for me."

Another trader is yelling across the room. "What is best market for Missile, Inc., stock?"

The chief trader glances at a set of pink sheets and replies, "Acme, Ganmor, Plush, and Continental all do it. Try Continental."

The tape is rolling off the private wire. A branch office is asking when trading will commence in Natural Resources, Inc., (Natural) stock. The chief trader replies, "At opening of the market tomorrow."

"But *B-D* Securities Company is already making a market," the branch office complains.

"Sorry, but they were not part of the underwriting group. Counsel advises we cannot commence trading until seven days from close of the underwriting.[2] All branch offices be prepared to give me your orders in the morning."

This, then, is a bird's eye view of a small segment of the over-the-counter market. A market consisting of thousands of securities dealers

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[1] The transaction described is a so-called riskless transaction effected on a principal basis. Under concepts developed by the Securities and Exchange Commission and the National Association of Securities Dealers, a dealer must, in this type of transaction, charge a price reasonably related to the market price. The dealer's mark-up in the illustration of 5¢ (25%) probably is enough to put him out of business. See Loss, SECURITIES REGULATION 850-62 (1951).

[2] Counsel is concerned with Rule 17 C.F.R. § 240.10B-6 (1955), adopted pursuant to § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b) (1952), which precludes a dealer from trading in a security it has underwritten until the distribution is completed. Since purchasers of the distributed shares in effect have 7 business days in which to pay, 48 Stat. 891 (1934), 15 U.S.C. § 78k(d) (1934); Securities Exchange Act Release No. 4044, Feb. 4, 1948; the underwriter does not know to what extent he may have cancellations until the 7 days have expired. Accordingly, out of an abundance of caution, counsel does not regard the distribution as completed until all shares have been paid for.

linked together by the sundry services of American Telephone & Telegraph Company, and constituting a multitude of individual decision-making centers, each with one objective—to realize a profit by selling shares for a few cents more than it pays for them. This profit-seeking objective, incidentally, provides an essential service to our system of capitalism, for it provides a secondary market for unlisted securities and thereby assures investors the liquidity so necessary to entice capital to venture.

The over-the-counter market consists of approximately 5,000 dealers who are members of the National Association of Securities Dealers (NASD) and a substantial number of nonmember 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 dealer's 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.

A dealer making a primary market in a security is prepared at all times, within limits, to buy or sell that security at the quoted price. Such a dealer must be prepared to assume a position, whether short or long,[3] in a security, in that it is seldom possible precisely to balance buy and sell orders at a particular price. Although there is little empirical evidence available, dealers making a primary market, on balance, probably tend to be long in the security. A dealer may make a primary market in several securities, or in only one or a few securities. There may be several dealers, or only a few dealers, and occasionally only one dealer making a primary market in a particular security. Even if several dealers make a primary market in a particular security, in many instances a particular dealer will effectuate a large percentage of the transactions.[4]

[3] A dealer who is short in this context has sold more shares than he has bought. A dealer who is long has bought more shares than he has sold.

[4] A dealer actively competing attempts to effectuate a large percentage of the transactions in the security by having the best market for the security—that is, by being willing to pay more for the security and to sell the security for less than other dealers.

The over-the-counter market is linked together by a teletype system, private wires, and the telephone. Although transactions are effectuated 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 is 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.[5] 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 over-the-counter market has no shape nor form. It is a desultory, unorganized, ill-defined market completely dependent on the whims, views, and decisions of thousands of dealers with no common denominator other than the profit motive. There is no central reporting agency and no way to determine the extent of a day's transactions in a particular security except in retrospect, and then inadequately.

II

Regulation of the Over-the-Counter Market

The typical over-the-counter securities dealer is subject to regulation by the appropriate state securities commission, the United States Securities and Exchange Commission, and the NASD. The NASD, although a voluntary organization, was formed pursuant to section 15A

[5] 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.

of the Securities Exchange Act of 1934,[6] and decisions of the Board of Governors of the NASD, disciplining dealers, are subject to review by the SEC. The bulk of the business conducted in the over-the-counter market is undoubtedly by members of the NASD. The NASD is divided into Business Districts, each with a full-time secretary and a small staff. The principal sanctions imposed by the Association are expulsion and suspension from membership, and fines. The initial decision is made by the District Committee, consisting of representatives of the industry within the District, and this decision is subject to review by a panel of the Board of Governors, also selected from the industry. The NASD is an outstanding example of industry self-regulation, and industry representatives have on occasion been notably severe in imposing sanctions on their own members—albeit, frequently against the less substantial ones. In practice, the SEC depends largely on the NASD to enforce mark-up policies and compliance with Regulation T.[7]

By and large, no real effort is made by the NASD nor state securities commissions to police market manipulations, and, accordingly, the functions of such commissions and the NASD in the regulation of the over-the-counter market are beyond the scope of this article. The SEC observes securities markets closely and is sensitive to rapid fluctuations in the market prices of securities. This article examines in detail the principles evolved by the SEC in policing over-the-counter-market trading activities.

III

The Market in Action

Returning to the narrative description of trading by the *X* Company and excerpting its trading activities in the stock of Natural Resources, Inc., (Natural) from its other trading activities, we left the chief trader advising the branch offices that he would open the market in Natural the following day.

Trading by the *X* Company commences the following morning in Natural stock:

The chief trader on teletype to *B-D* Securities Company, which,

[6] 52 Stat. 1079 (1938), 15 U.S.C. § 78o-3 (1952).

[7] Regulation T regulates the extension of credit by broker-dealers in securities transactions and has been adopted by the Board of Governors of the Federal Reserve System pursuant to § 7(a) of the Securities Exchange Act of 1934, 48 Stat. 886 (1934), 15 U.S.C. § 78g(a) (1952).

as previously noted, has been making a primary market in Natural: "Market, please, in Natural."

B-D Securities Company: "Twelve-fifteen."

The chief trader to branch offices and salesmen: "Orders and indications for Natural stock, please."

The chief trader is advised as to orders and indications of interest, which suggest more potential buyers than sellers.

The chief trader to branch offices and salesmen: "Retail market [market to customers] Natural eleven cents bid, sixteen cents ask; inside market [market to other dealers] twelve cents bid, fifteen cents ask."[8]

Trading ensues at these prices until the *X* company is short 40,000 shares. The chief trader raises his retail quotation to fifteen cents bid—eighteen cents ask and attempts to buy at the current bid price sufficient shares to cover sales at the previous ask price.[9] As his short position continues for a period of several days, the *X* Company trader continues to raise his bid and ask prices, but he raises his bid price only to the extent he believes necessary to buy sufficient shares to cover at a profit sales at his last ask price. By the end of two weeks, the market made by the *X* Company is twenty cents bid—twenty-two cents ask, and the *X* Company is still several thousand shares short. Numerous sellers now appear at the current bid price, and the chief trader buys only enough shares at this price to cover his short sales at twenty-two cents, then reduces his price to eighteen cents bid—twenty cents ask.[10] Supply continues to exceed demand, and the trader successively lowers his bid and ask prices, buying shares at the current bid price only to the extent he is short shares at a price above the current bid price and to the extent necessary to supply current demand.

In the meantime, an SEC staff member in Washington has been scanning the Daily Quotation Sheets over a period of several days, and

[8] The significance of this opening quotation and the manner in which it was determined is discussed *infra* at p. 210. A penny stock is used for illustrative purposes to avoid the inconvenience of using fractions.

[9] Presumably the *X* Company has sold 40,000 shares at 16¢ in excess of what it has bought at 11¢. Accordingly, the *X* Company will realize a profit on all shares bought at its current bid price of 15¢ up to 40,000 plus the shares it is able to sell at its current ask price. However, maintaining a spread between bid and ask price sufficient to permit covering a short position at a profit in this manner may evidence control and domination of the market. Sterling Securities Co., Securities Exchange Act Release No. 6100, Nov. 2, 1959.

[10] For example, assuming the *X* Company was short 10,000 shares, which it sold at 22¢, the *X* Company buys 10,000 shares (plus additional shares needed to cover current sales at 22¢, if any), but no more at 20¢, and then lowers its bid to 18¢.

has noted the increase in quotations of Natural from eleven cents bid to twenty cents bid. A preliminary inquiry is made to determine whether there have been significant developments in the affairs of Natural to warrant the price increase, and the answer appears to be negative. An investigation file is opened, and a staff member is assigned to conduct a trading quiz. As part of the trading quiz, a trading inspector examines all of the trades in Natural by the *X* Company during a specified period. The transactions of other dealers known[11] to or likely to have trades in Natural during the same period are determined by direct examination or questionnaire. The result is a composite schedule showing every known transaction in Natural during a specified period, the name and address of every buyer and seller, and the price at which each transaction was effected. A representative group of purchasers of Natural during this period is interviewed. The staff recommends and the Commission enters an order directing the opening of a proceeding to determine whether the broker-dealer registration of the *X* Company should be revoked.

A. The Charge

The Commission's order alleges reason to believe that the *X* Company, for the period February 1, 1959, to April 30, 1959, violated section 17(a) of the Securities Act of 1933,[12] section 10(b) of the Securities Exchange Act of 1934 and rules thereunder,[13] and section 15(c)(1) of the Exchange Act of 1934 and rules thereunder,[14] in that it willfully made false statements and omitted to state material facts concerning, among other things, the market for Natural stock, the market price of the stock, and the *X* Company's domination and control of the market. The action sounds in fraud—the failure to disclose control and domination, thereby making misleading the implied representation that the prices charged were determined in a free and competitive market.[15]

Section nine of the Securities Exchange Act of 1934, the anti-

[11] The SEC investigator determines who has transactions in a particular security by noting the dealers who place quotations for the security in the Sheets, by examination of one dealer's records disclosing transactions with other dealers, and by inquiry of other dealers who may be familiar with this particular trading market.

[12] 48 Stat. 84 (1933), 15 U.S.C. § 77q(a) (1952).

[13] 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1952); 17 C.F.R. § 240.10b-5 (1949).

[14] 48 Stat. 895 (1934) 15 U.S.C. § 78o(c)(1) (1952); 17 C.F.R. § 240.15c-2 (1949).

[15] R. L. Emacio & Co., 35 S.E.C. 191 (1953).

manipulation section, does not refer to control and domination as being unlawful, but generally makes unlawful

1. wash sales;[16]

2. matched orders,[17] entered into for the purpose of creating a false or misleading appearance of active trading;

3. creating actual or apparent trading in a security or raising the price of a security for the purpose of inducing others to purchase;[18] and

4. false representations pertaining to a security while buying and selling such security.[19]

Although section nine by its terms is limited to securities listed on a national securities exchange, the Commission has made section nine applicable to registered dealers trading in over-the-counter securities.[20] The Commission has rejected the argument that since the over-the-counter market is a private market in which transactions are not publicized, the antimanipulation provisions are not applicable.[21] Nonetheless, the Commission's staff was impressed with the argument to the extent that the failure to disclose domination and control of the market rather than violation of the antimanipulation provisions is the ground generally relied upon as the basis of the charges. Inasmuch as the cases are tried in a fraud context, it would appear that a dealer could avoid control and domination charges by disclosing the fact of such control and domination. However, when one dealer informed customers that he manipulated a particular market, the Commission held that this disclosure was not sufficient, because the dealer failed to disclose that such manipulation was unlawful.[22] Presumably, the activity

[16] A wash sale of a security involves a sale in which there is no change in the beneficial ownership of a security. 48 Stat. 889, 15 U.S.C. § 78i(a)(1) (1952).

[17] A matched order consists of an order to purchase or sell a security, with the knowledge that an offsetting order or orders of substantially the same size, at substantially the same time, and at substantially the same price, has been or will be entered by or for the same or different parties. 48 Stat. 889, 15 U.S.C. § 78i(a)(1) (1952); Wright v. SEC, 112 F.2d 89 (2d Cir. 1940).

[18] 48 Stat. 889 (1934), 15 U.S.C. § 78i(a)(2) (1952); M.S. Wien & Co., 24 S.E.C. 4 (1946); Kidder, Peabody & Co., 18 S.E.C. 559 (1945). Although the manipulation provisions are applicable to deliberate efforts to depress the price of a security, because of the infrequency of such situations, they are not discussed in this article.

[19] 48 Stat. 889 (1934), 15 U.S.C. § 78i(a)(4) (1952).

[20] 17 C.F.R. § 240.15c1-2 (1949); Barrett & Co., 9 S.E.C. 319 (1941).

[21] Halsey, Stuart & Co., 30 S.E.C. 106, 127 (1949). The Commission recently reaffirmed this view in Gob Shops of America, Inc., Securities Act Release No. 4075, May 6, 1959.

[22] Shelly-Roberts & Co., Securities Exchange Act Release No. 5837, Dec. 22, 1958.

was unlawful because of section nine,[23] in which event disclosure could not have remedied the situation. As is noted below, the theory adopted can affect the practical consequences to dealers.

B. The Proof

The Government's case as presented at the hearing is essentially documentary and represents a summary of the information obtained in the trading quiz and information gathered from the National Daily Quotation Sheets. A summary of the Government's summary of the trading quiz discloses the following:

TRADING IN NATURAL RESOURCES, INC.

Period	Market Range		Number of days traded	All Known Dealer Transactions			Transactions by X Company				
				Purchases	Sales	Total	Purchases	Sales	Total	Days Traded	Percent of Total
2/6/59 thru 4/20/59	11c low bid	20c high bid	50	1,000,000	950,000	1,950,000	850,000	925,000	1,775,000	48	93%

In addition, the following appears: The *X* Company placed quotations in the Daily Quotation Sheets on all fifty trading days; on thirty-five of the trading days, it was the only dealer to place quotations in the sheets; on forty-five of the trading days, it had the highest bid in the sheets; the *X* Company's purchases on six occasions raised the price of the stock; the *X* Company raised its bid price in the sheets on five occasions; and the *X* Company repurchased shares from other dealers and customers at prices higher than it had previously sold them to such dealers and customers.

The *X* Company's evidence establishes the trading pattern heretofore outlined.

C. The Classical Manipulation Distinguished

The case established by the Commission's staff is not the classical manipulation. As long as some men are moved by the desire to make a "killing," the classic manipulator will be with us. In essence, his

[23] Section 9(a)(3) of the Securities Exchange Act of 1934 provides (with respect to a listed security) that it is unlawful to represent that the price of a security will increase as the result of any person's market activities. 48 Stat. 889 (1934), 15 U.S.C. § 78i(a)(3) (1952).

scheme is a comparatively simple one, involving the raising of the price of a security by a series of purchases designed to (1) restrict the floating supply, (2) create the appearance of activity, and (3) cause others to purchase the security as the result of the apparent activity and rising prices.

If the manipulator is an over-the-counter dealer, these activities are supplemented by inflated quotations in the National Daily Quotation Sheets and the local newspapers. The dealer in this situation may be encouraging his salesmen to create activity through false representations as to the Company's prospects and may have in his employ paid touts, including other dealers, who are induced also to place quotations in the Sheets and who run subsidized newspaper ads recommending the manipulated security. The motive is not difficult to find—(1) either the dealer owns or has under option a large block of stock which he disposes of at the manipulated price, or (2) the dealer is conditioning the market for a public offering by the issuer which the dealer is to underwrite. The Commission has found this type of manipulation in numerous cases.[24]

IV

Domination by the Specialist

The "Government's" case as outlined does not fit into the classical manipulation pattern. Rather the pattern is one common to the trading activities of many over-the-counter dealers specializing in and making a market in a particular over-the-counter security. The disturbing fact is that the Commission's staff apparently regards such activities as unlawful, at least when coupled with retail sales, and the Commission not only has relied in large part on this type of evidence in drawing the inference that a dealer "controlled and dominated" a market, but has used language in its opinions tending to confirm the views of the staff. The Commission's decisions are usually clouded by the fact that it resists efforts to fractionate the staff's case and generally has considered the foregoing type of evidence with other more apparent evidence of manipulation in drawing the inference of control and domination.

The Commission has indicated that one of the evils involved in this situation is the failure of the dealer to disclose that he is the principal

[24] R.J. Koeppe & Co. v. SEC, 95 F.2d 550 (7th Cir. 1938); Michael J. Meehan, 2 S.E.C. 588 (1937); Charles C. Wright, 3 S.E.C. 190 (1938); Harold T. White, 3 S.E.C. 466 (1938); Barrett & Co., 9 S.E.C. 319 (1941); The Federal Corp., 25 S.E.C. 227 (1947); R. L. Emacio & Co., 35 S.E.C. 191 (1953).

(if not only) market for the security. The Commission has stated in this regard:[25]

> . . . 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 security.

Disregarding the question-begging terms "support" and "dominating," we may have isolated the real culprit—the failure to disclose that since *X* dealer is the only dealer making a market in the security, if he should discontinue making such market, there might very well be no market for the security. If this is the evil aimed at, a remedy is available—disclosure. This disclosure could be accomplished in part by placing in the confirmation statement the following or similar legend: "*X* Company makes a primary market in the security confirmed and may from time to time be the only market for the security." The problem of making the disclosure prior to the transaction is a more cumbersome one, and the writer has no feasible suggestions for its solution.[26]

The Commission has an express rule precluding a dealer from representing in a primary or secondary distribution that the shares are being offered "at the market" or at a price related to the market price, 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.[27] The over-all effect of the foregoing decision may be to apply similar principles to the over-the-counter market generally, although the fact that the rule is more limited in scope is some basis for contending that the Commission deliberately refrained from adopting this position. In any event, since the Commission finds an implied representation that the price quoted by a dealer is the market price,[28] it may be necessary, from a disclosure standpoint, to negative such implied representation.

[25] S. T. Jackson & Co., 36 S.E.C. 631, 656 (1950).

[26] A comparable problem occurs with respect to 17 C.F.R. § 240.15C 1-5 (1949), which requires a broker-dealer controlling an issuer to disclose this fact in all transactious with customers pertaining to such issuer before entering into any contract. One possible solution is to make the disclosure in the confirmation and provide that the customer has 24 hours to accept or reject the transaction.

[27] *Id.* § 240.15C 1-8.

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

The vice of a manipulation, the Commission has said, is that it distorts ". . . the character of the market as a reflection of the confirmed judgment of buyers and sellers, and . . . make[s] of it a stage-managed performance. . . ."[29] This type of evil probably cannot be remedied by disclosure; the antimanipulation provisions of the Securities Exchange Act of 1934 expressly recognize this fact by making it unlawful for a person to represent that the price of a security is likely to increase as the result of his (or someone else's) market activities.[30] Do the ordinary trading practices of an over-the-counter specialist involve this type of market interference? The over-the-counter dealer making the primary market in a local security which is infrequently traded, or in a security in which there is a so-called "thin market" or in which the market is virtually nonexistent, is relatively free of market forces and dominates and controls the market.[31] Thus, the activities of the dealer have been found to constitute control and domination because of the presence of all of the following factors:[32]

1. the limited size and very local character of the market;
2. the unlikelihood of an independent market developing;
3. the dealer's customers posed special trust and confidence in him, relying on his recommendations implicitly; and
4. as a result of the dealer's relationship with his customers, he controlled their investment decisions and used such control to cause some customers to buy and others to sell—in effect, his customers were buying and selling on the dealer's recommendation, at prices he determined.

A dealer buying from and selling to customers on the basis of such a market must make the fullest disclosure as to the nature of the market, and in many instances must as a minimum disclose that there is, in fact, no market.[33] Even in the light of the most complete disclosure, as discussed above, the dealer's control and domination may be unlawful. Accordingly, in this type of situation, a broker-dealer would be well advised to inform the customer that there is no market in the

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[29] Halsey, Stuart & Co., 30 S.E.C. 106, 112 (1949).

[30] 48 Stat. 889 (1934), 15 U.S.C. § 78i(a)(3) (1952).

[31] W. K. Archer & Co., 11 S.E.C. 635 (1942), *aff'd*, 133 F.2d 795 (8th Cir. 1943); Norris & Hirshberg, Inc., 21 S.E.C. 865 (1946). *Cf.* Indiana State Securities Corp., Securities Exchange Act Release No. 5602, Nov. 18, 1957.

[32] Norris & Hirshberg, Inc., 21 S.E.C. 865 (1946).

[33] W. K. Archer & Co., 11 S.E.C. 635 (1942), *aff'd*, 133 F.2d 795 (8th Cir. 1943).

security and attempt to effect the transaction as the agent for the customer at the best obtainable price.

Eliminating the "thin market," which probably is per se a controlled and dominated market, does the over-the-counter specialist effecting a large percentage of the transactions in a security dominate and control the market? In the *Norris & Hirshberg* case, the Commission indicated otherwise if the possibility of an independent market arising exists and if the specialist is selling and buying to and from other dealers and informed customers, stating in this regard:[34]

> Every over-the-counter dealer who "specializes" in a security, in the sense that he effects a high percentage of the transactions in the security, and in the sense that he is the principal buyer and seller and is most familiar with the affairs of the issuer and the state of the market, to some extent dominates the market in that security. His trading volume may be the backbone of the market in the security and his determination to pay more or less may be determinative of market movements. However, to the extent that he does business with dealers or with informed members of the public who have access to information about issuers and quotations and can weigh investment in the security as against investment in others, and to the extent that there exists the possibility of an independent market in the security, the over-the-counter specialist's decisions about pricing are subject to the check of free and competitive forces.

Despite this decision, in *M. S. Wien & Co.*, the Commission appeared to use "dominate" as being synonomous with "making the market," stating: ". . . . Although there appears to have been a small amount of independent buying interest, respondent knew that it dominated and was, in fact, making the market in Phoenix debentures. . . ."[35] There were other activities more characteristic of the traditional manipulation present in the *Wien* case. However, in the *Daniels* case,[36] which was uncontested, the evidence merely established that the dealer traded the particular security and was almost wholly responsible for the quotations in the Sheets. The Commision found: ". . . . Thus the market . . . was maintained and dominated by registrant. . . ."[37]

The *S. T. Jackson & Co.* case[38] gives little comfort to the over-the-counter specialist. The tabulation summarizing trading activities of

[34] Norris & Hirshberg, Inc. 21 S.E.C. 865, 874-75 (1946).

[35] M. S. Wien & Co., 24 S.E.C. 4, 13 (1946). See also Sterling Sec. Co., Securities Exchange Act Release No. 6100, Nov. 2, 1959.

[36] Daniels & Co., Securities Exchange Act Release No. 5549, July 18, 1957.

[37] *Ibid.*

[38] 36 S.E.C. 631 (1950).

our fictional dealer above is an adaptation of a similar table relied on in large part by the Commission in finding that Jackson & Co., controlled and dominated the market.[39] The *Jackson* case purported to rely on the *Norris & Hirshberg* case and perhaps can be reconciled with the language of that case on the basis that no real possibility of an independent market arising existed in the *Jackson* case. The Commission has found no violation with respect to the trading activities of a dealer making the primary (but not exclusive) market in a security, effectuating approximately two-thirds of the trades, and being the only dealer in the Sheets for approximately two months, where considerable activity by other dealers subsequently developed.[40] On the other hand, the fact that twelve dealers placed quotations in the Sheets has not precluded the Commission from finding that a particular dealer controlled and dominated the market.[41]

Primary markets in many over-the-counter securities do not conform to the textbook concept of pure competition, in which no one person at any time determines the market price. The dealer making the primary market must at any given time determine bid and ask prices and the size of his inventory or short position, which determinations may result in lowering or raising the price. Nonetheless, he is subject to competitive forces, in that if he performs his function properly, his price will be responsive to supply and demand. If the dealer, for example, makes his market fourteen cents bid and eighteen cents ask and has a large number of buyers and few sellers at these prices, he cannot indefinitely buy stock at fourteen cents per share. Ideally, he seeks to find a price level at which supply and demand are in balance. The fact that the dealer has participated in a large percentage of the transactions does not establish that he failed to perform this function. It is only when the dealer attempts arbitrarily to raise, lower, or maintain prices that there is a stage-managed performance.[41a]

The foregoing view and ideal of a dealer making a primary market, as merely acting as a conduit from buyer to seller (and seller to buyer), may be naïve in the light of the actual trading practices of many

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[39] *Id.* at 661.

[40] Edgerton, Wykoff & Co., Securities Exchange Act Release No. 5263, Dec. 7, 1955.

[41] Gob Shops of America, Inc., Securities Act Release No. 4075, May 6, 1959.

[41a] The Commission, however, appears to regard the exercise of discretion by a dealer in determining his market quotation the equivalent of arbitrarily established prices, stating, "We find that . . . registrant . . . fixed the prices of such stock . . . [and] . . . trade[d] with their customers on the basis of such arbitrarily established prices." Sterling Sec. Co., Securities Exchange Act Release 6100, Nov. 2, 1959.

dealers. Although empirical data is not available, it is likely that many dealers are generally trading against a long position and are bullish concerning the future price trend of the security. Merely to attempt, in effect, to match buy and sell orders involves risks that many dealers are not willing to assume. It may be helpful with this background to examine particular trading practices, in an effort to distinguish between normal trading practices and activities designed artificially to establish prices.

V

Normalcy and Abnormalcy in the Marketplace

Natural Resources, Inc., stock, as has been noted, was offered to the public at ten cents per share. Prior to the public offering, there was no trading market in the security. The *X* Company, as underwriter, probably started with a short position, for typically an effort is made to oversell an issue and thereby provide buying support upon commencement of trading. All other factors being equal, the trader would normally open the market at that offering price—*e.g.*, nine cents bid—ten cents ask, or at a quotation straddling the offering price—*e.g.*, nine cents bid—eleven cents ask. However, the trader for the *X* Company opened the market at eleven cents bid—sixteen cents ask, or six cents above the public offering price. The trader was influenced in this decision by the fact that (1) the *X* Company was short the security, (2) considerably more buying than selling interest was evident, and (3) trading had developed at these higher levels away from him. This type of situation would normally occur only with respect to an issue that has been oversubscribed. The Commission's staff apparently will regard with suspicion, at least when coupled with other circumstances, the opening of a market at an ask price substantially above the public offering price.[42]

In the *Jackson* case, the Commission considered the following trading practices as being particularly significant:

1. On not less than eight occasions (during an eight-month period), the respondent dealer engaged in purchase transactions (for its customer) that raised the market price of the security.

[42] Brief for the Division of Trading and Exchanges, In the Matter of Sterling Securities Co., S.E.C. Docket Nos. 8-4738, 8-5485, 8-4860. The Commission, while not emphasizing the opening quotation, regarded as significant the fact that ". . . during the first day's trading registrant advanced the price to 21 cents per share, which was more than twice the Regulation A offering price. Sterling Sec. Co., Securities Exchange Act Release No. 6100, Nov. 2, 1959.

2. No time was allowed to intervene between the price-raising transactions and the dealer's own sales.

3. The dealer increased the price of the security over the previous transaction in cross-transactions between customers.

4. The dealer repurchased shares from other dealers and from customers at prices higher than such customers and dealers had previously paid respondent dealer.

Although there were other factors in the *Jackson* case, as discussed below, the particular practices listed above are characteristic of any dealer's activities in a rising market. If, for example, demand exceeds supply and the dealer is attempting to purchase the security for a customer (or to fill his trading needs), the dealer may have to pay more than the price of the last transaction.[43] Further, if he is to continue trading in the security, he will have to sell shares at a price above his price for the last transaction,[44] and if the market continues to rise, he

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[43] Although difficult to determine from the discussion, it appears that in the *Jackson* case, the broker-dealer at the time of the price-raising transactions was actually relying primarily on another dealer's market. Assume, for example, the other dealer's market had been 1½ ask, 1⅜ bid, and the last transaction took place at 1½; the respondent-dealer, acting as agent for his customer, bid 1⅝ for the customer and thereby raised the price by ⅛ of a dollar. In another instance, the dealer apparently sold the security as principal to the customer from inventory at $2.00 when his (or other dealers') markets had previously been, for example, 1⅞ ask, 1⅝ bid, and the last transaction had taken place at 1⅞. As to the agency transaction, it is quite conceivable that although the market had been 1½ ask, 1⅜ bid, that the broker-dealer acting for his customer was unable to find stock available at 1½, and in order to obtain the stock, had to bid 1⅝. As to the principal transaction, assuming a market of 1⅞ ask, 1⅝ bid, if the dealer is, on balance, short at this quotation—that is, he is selling more shares than he is buying—it is obviously appropriate to raise his market to, *e.g.*, $2.00 ask, 1⅝ bid. Nonetheless, raising the bid price, buying at the higher bid price, and placing increasing bid prices in the Sheets are relied on in large part by the Commission in finding a manipulation. Barrett & Co., 9 S.E.C. 319 (1941); Harry Marks, 25 S.E.C. 208 (1947); Adams & Co., 33 S.E.C. 444 (1952); R. L. Emacio & Co., 35 S.E.C. 191 (1953). The Commission has stated ". . . . The insertion of increasingly higher bids in the sheets is the most universally employed device to create a false appearance of activity in the over-the-counter market. . . ." Gob Shops of America, Inc., Securities Exchange Act Release No. 4075, May 6, 1959.

[44] If the dealer is both buying and selling, as he ordinarily is, this is obviously true if his last transaction was a purchase, for the dealer is in the business of selling at a profit. Turning to the agency transaction described in note 43 *supra*, if the broker, in good faith, had to pay another dealer 1⅝ in filling his customer's order, then he would appear to be justified in making his market at 1⅝ ask or higher. It might have been appropriate in this context to determine whether the broker had been instructed to act as agent. What the Commission is inferring is that the broker deliberately acted as agent and deliberately reached for stock at a higher price in order to establish a higher price level, at which he could then sell shares as principal to his

may very well find himself repurchasing shares from persons who purchased the shares from him for less.[45] As to the cross-transactions at a price above the previous purchase, if the dealer's market is, for example, fourteen cents bid—eighteen cents ask and he receives an agency order to sell at sixteen cents and an agency order to buy at sixteen cents, there appears to be no reason why he should not cross the transaction at sixteen cents, even if it results in a price above his last purchase.[46]

The thrust of the market activities that are generally viewed with suspicion is to raise the price of the security. In the *Jackson* case, the Commission appeared to regard price-raising in itself as condemnable, without distinguishing the trading situation from the classical situation, in which the dealer is constantly buying at increasing prices for inventory (and thereby restricting the floating supply) rather than for trading purposes. There were, however, other factors in the *Jackson* case that undoubtedly affected the Commission's analysis. For example, the dealer bought shares for his customer in a transaction that raised the price of the security at a time when he could have covered the transaction from his inventory.[47] There was also evidence of the fact that

customers. With respect to the principal transaction referred to in note 43 *supra*, if the dealer raises his market for the reason stated, he must obviously continue to sell at the increased ask price.

[45] Undoubtedly the *X* Company in this situation would have repurchased shares at the higher price level from prior purchasers willing to take their profit.

[46] The *Jackson* case situation is not too clear, but apparently the broker had obtained agency orders to buy at 2¼ and to sell at 2¼ when the quotation immediately preceding the last transaction had been 2⅛ ask—2 bid. It is quite conceivable that stock was no longer available at 2⅛ and 2¼ was the best available price. That this may have been the situation is indicated by the footnote acknowledgment that the market away from the respondent dealer reached 2½ on the same date. S. T. Jackson & Co., Inc., 36 S.E.C. 631, 652 n.44 (1950). It is also possible, assuming a principal transaction, that the market had been 2 ask—1⅞ bid, and the dealer had effectuated his last sale at $2.00 and then raised his market to 2¼—$2.00 because of his position in the security or other factors tending to indicate more demand than supply. In this situation, if he should receive orders on both sides which are inside his quotation (*e.g.*, he has a would-be seller at 2¹⁄₁₆ and a would-be buyer at 2⅛), he undoubtedly will and should cross transactions.

[47] An analysis of this transaction requires consideration of certain factors that were not discussed in the case. Assume a 1⅞ ask—1⅝ bid market that because of the market situation, becomes a 2⅛ ask—1⅞ bid market by a broker-dealer who receives an agency buy order from a customer at $2.00. The broker-dealer's market now becomes (at least until he completes this transaction) 2⅛ ask, 2 bid (the bid being, in effect, made for his customer). If the broker succeeds in completing this transaction for the customer, he has raised the price of the security over the prior 1⅞ ask price, as he would have with respect to the first sale made at the higher quotation. What the

on five days, other dealers effected transactions for customers at prices lower than Jackson effected transactions for its customers. Although not present in the *Jackson* case, the Commission has looked askance at a dealer raising his bid price to or above the price at which he was contemporaneously selling the security short.[48]

The Commission has quite correctly regarded the concentration of securities in a few hands as a situation that restricts the floating supply of the security.[49] On the other hand, it has also regarded the distribution of securities to a large number of persons, each buying a small number of shares, as part of a pattern designed to restrict the floating supply.[50] This seems somewhat incredible, particularly in the light of the fact that the bulk of the securities involved came from the alleged manipulator, who obviously would control the floating supply better by retaining the securities in inventory. The Commission seems to have been influenced by the fact that a portion of the securities involved came from a number of investors who the dealer knew were desirous of selling and went to persons who obviously had a less immediate desire to sell. This, of course, is characteristic of any market, in that it is not possible to have a market without having both persons willing to sell as well as persons willing to buy. There was an obvious motive for manipulation present in this case as well as other incriminating circumstances.

There are many practices that are indicative of the fact that the dealer is not attempting to tamper with market forces, but rather is controlled by them. Particularly significant are the following:

1. The dealer not only raises his bids, but as the occasion demands, he lowers his bids.[51]

Commission apparently is suggesting in this situation is that so long as the dealer has an inventory (a long position), the dealer must justify any increase of the market price by him as a dealer or in effectuating agency transactions for customers.

[48] Gob Shops of America, Inc., Securities Act Release No. 4075, May 6, 1959. Although the inference drawn by the Commission was probably a reasonable one under the circumstances, the market situation could change so rapidly that a dealer is bidding a higher price than the price at which he sold the security a few minutes earlier.

[49] Barrett & Co., 9 S.E.C. 319, 327 (1941), in which the Commission defined the floating supply of a stock as "that part of the issue which is outstanding and which is held by dealers and the public with a view to resale for a trading profit, as distinguished from that part of the stock held for investment." Withholding agreements designed to limit and control the supply must be disclosed. SEC v. Otis & Co. 18 F. Supp. 100 (N.D. Ohio 1936).

[50] Gob Shops of America, Inc., Securities Act Release No. 4075, May 6, 1959.

[51] Edgerton, Wykoff & Co., Securities Exchange Act Release No. 5263, Dec. 7, 1955. Sales contemporaneous with purchases have been considered as a factor in finding no manipulation. Harold T. White and Francis M. Weld, 3 S.E.C. 466 (1938).

2. The dealer is not only long in the security, but from time to time, he is truly short in the security—*i.e.*, he has no assured supply.[52]

3. The dealer is not buying a significant amount of the security in excess of what is needed to fill demand. He is continually and contemporaneously selling as well as buying the security.

However, the fact that the dealer is attempting to stabilize or maintain the price of a security, as distinguished from raising the price, is not ordinarily a defense in manipulation cases.[53] This type of market interference is permitted in certain situations, but only in the appropriate situation and when undertaken in conformity with the stabilization rules adopted by the Commission.[54]

VI

Stimulants Prohibited

There is another important element very much present in many alleged over-the-counter manipulation situations. Although the Commission has not expressly said so, this may be the distinguishing factor in many instances. Dealers, as we have noted, may be wholesale dealers, retail dealers, or a combination of both. An over-the-counter manipulation frequently involves a dealer who not only makes a principal (if not the only) market in the security, but also retails the security. A considerable portion of the demand for the security is likely to have been generated by the efforts of the dealer's sales force, which is merchandising the security against the dealer's long position. If the dealer sells at retail a security that he positions, he may have induced, through his salesmen, the publication of optimistic reports, and the like, a substantial portion of the demand for the security. This demand results in raising the price of the security, and the rising price in itself generates additional demand from people expecting the price to go even

[52] The Commission has held that this fact was not sufficient in the circumstances of the particular cases to preclude drawing the inference that the dealer controlled and dominated the market. Gob Shops of America, Inc., Securities Act Release No. 4075, May 6, 1959. Although the Commission did not rely on this fact, the fact that the dealer had warrants from the Company to purchase 86,118 shares, when its short position was approximately 26,000 shares, was undoubtedly significant, even though the dealer would have undoubtedly violated the registration provisions of the Securities Act of 1933, 48 Stat. 77 (1933), 15 U.S.C. § 77e (1952), if these shares were used to cover the short position.

[53] Masland, Fernon, & Anderson, 9 S.E.C. 338 (1941). *But cf.* Harold T. White & Francis M. Weld, 3 S.E.C. 466 (1938).

[54] 48 Stat. 889 (1934), 15 U.S.C. § 78i(a)(6) (1952); 17 C.F.R. § 240.10B-7 (1955); Loss, *op. cit. supra* note 1, at 922.

higher. At the same time, the increased price produces a supply of stock to supplement the dealer's inventory from persons willing to take their profits.

In practice, all may not work out in this manner, or there may be variations of the pattern. A sufficient supply of stock may not be forthcoming, in which event the dealer soon finds himself in a substantial short position. To realize a profit in this situation, the dealer must actually look for a decrease in the price of the stock to the point where he can cover his short position at a profit, or take his loss on the initial trading and recoup the loss and earn a profit at the new and higher price level. The Commission's staff in this situation is likely to look for a secret source of supply to the dealer, fictitious trading accounts, trading accounts in the name of a nominee, etc.

The focus of attention in this area should be (but has not been) the manner in which the demand has been created. The manipulation provisions of the Securities Exchange Act of 1934 contain a seldom-used provision designed directly to attack stimulated demand. It is unlawful, in effect, while trading in a security, to make a false or misleading statement of a material fact relating to the security.[55] The Commission's staff has usually not undertaken the difficult task of proving false or misleading statements as such. In many instances, since the representations are usually oral, recollections are vague, or the representations are primarily puffing or statements of opinion, a traditional fraud case would be difficult to prove. Or, indeed, in many instances, the representations as such are not actionable. The Commission's staff in such cases is likely to allege fraud because of failure to disclose the alleged control and domination of the market. Although this has never been articulated, what the staff appears really to be complaining about in these cases is the failure to disclose that the dealer, while making a primary market in a security, has stimulated the demand for the security.

The status of the law in this area is anything but clear. Stimulation of the demand undoubtedly has been an influencing, if not decisive, but inarticulate factor in the decisions in which the Commission has done little more than cite a conglomeration of statistics relating to the trading in the security and conclude that the respondent controlled and dominated the market. Such statistics frequently have proven, if anything,

[55] 48 Stat. 889 (1934), 15 U.S.C. § 78i(a)(3) (1952); 48 Stat. 895 (1934), 15 U.S.C. § 78o(c)(1) (1952); 17 C.F.R. 240.15C 1-2 (1949); Barrett & Co., 9 S.E.C. 319 (1941).

no more than that the dealer was the principal market in the security during a given period of time.

The Commission made an early effort to establish that deliberate stimulation of demand through the dissemination of information and recommendations constituted a violation of section nine of the Securities Exchange Act of 1934. A district court, in fact, subscribed to the theory that such acts violated section nine because they were designed ". . . to draw in other persons who would be attracted by increased activity at rising prices. . . ."[56] Section nine precludes a person, alone or with other persons, from effecting a series of transactions in a security for this purpose. To reach the position of the court noted above, it is necessary to conclude, in the absence of actual transactions by the respondent, that the respondent effected such transactions by inducing other persons to purchase the security. The Commission has not applied the same logic to the over-the-counter situation, but has regarded as a significant part of the over-all pattern of control and domination the fact that the bulk of the demand resulted from an intensive sales campaign by the dealer's thirty-five-man sales force.[57] In the *Jackson* case, reliance was placed by the Commission on representations made by the salesmen relating to the Company's business prospects and the potential market value of the security. The Commission concluded that such representations were false, which in itself constitutes a violation, aside from any control and domination question.

The *Norris & Hirshberg* case, as previously noted, suggested that a dealer does not unlawfully dominate the market because he is the principal market to the extent that he does business with informed customers and the possibility that an independent market exists.[58] This suggests that combining retail business with the making of a principal

[56] SEC v. Torr, 15 F. Supp. 315, 318 (S.D.N.Y. 1936). Although the court used this language in referring to the effect of the dealer's recommendations, there were, in fact, significant purchase transactions by the dealer.

[57] Gob Shops of America, Inc., Securities Act Release No. 4075, May 6, 1959. The Commission has also talked in terms of a free market as being something other than a stimulated market: ". . . the manipulator's design in raising prices is to create the appearance that a free market is supplying demand whereas the demand in fact comes from his planned purpose to stimulate buyers' interest." Halsey, Stuart & Co., Inc., 30 S.E.C. 106, 112 (1949).

[58] It is interesting to note that the Commission has held that other dealers and informed customers are entitled to rely on representations (usually implied ones) as to the market being a free and competitive one. Russell Maguire & Co., Inc., 10 S.E.C. 332 (1941); M. S. Wien & Co., 24 S.E.C. 4 (1946); Halsey, Stuart & Co., 30 S.E.C. 106 (1949). Yet, whether the market is a free and competitive one may, as noted in the text, depend on the degree of sophistication of the particular dealer's customers.

market is not per se defective; however, doing business in this type of situation with customers posing special trust and confidence in the dealer ("fiduciary protected customers") may be fatal. Although in the context of the case "informed customers" appears to refer to anyone other than the "fiduciary protected customer," the Commission's staff apparently would apply this concept to a market in which the dealer making the primary market generates demand by soliciting relatively uninformed (but not "fiduciary protected") persons.

VII

The Subtle Motive

The traditional manipulator has an apparent motive—namely, to dispose of a bloc of stock at manipulated prices. The manipulator may own the stock, may have it under option, or may be the proposed underwriter of a new issue of the security. In many instances, the existence of an obvious motive to increase the price of the stock coupled with the fact of such increase may largely induce the fact-finder to draw an inference of domination and control from inconclusive data.[59]

The motive the Commission's staff discerns in control and domination by a dealer making a primary market is the desire for trading profits. This, of course, is the objective of all dealers making a market in a security, and, accordingly, all dealers are suspect in this regard. If, as is likely, dealers making a primary market are, on balance, long in the security—that is, they generally are buying slightly more shares than they are selling—their desire for a rising market is apparent. If the dealer is not long in the security, he may have a known source of supply of the stock from certain large stockholders, which reduces his risk. The dealer may have an apparent short position, but, in fact, have fictitious or nominee accounts or an arrangement by which he knows he can cover his short position by purchases from a holder of a large bloc of stock. Further, an active trading market is likely to be a profitable trading market, particularly if the price trend is upward. Hence, the constant interest of dealers in stimulating demand.

[59] Although the Commission's staff as the proponent of an order has the burden of proof under the Administrative Procedure Act, 60 Stat. 241 (1940), 5 U.S.C. § 1007(c) (1952), the Commission has generally found a violation in all instances in which a motive for manipulation exists. See cases in notes 24, 25, 28, 29, & 41 *supra*. *Cf.* the inference-drawing function as performed by a court in SEC v. Andrew S., 1 S.E.C. Jud. Dec. 265 (S.D.N.Y. 1936).

VIII

The Delicate Art

The classical manipulation requires little expertise to comprehend. However, trading in securities, to the extent it involves making a primary market, is an art requiring considerable finesse. Expertise in this area cannot be acquired by anything other than actual experience. The trader makes numerous quick decisions, many of them under conditions of stress and tension. The trader does not have available data reflecting actual transactions by other dealers and does not know many important facts, such as size, concerning the market being made by a competitor. He must gauge supply and demand at various price levels, with a reasonable degree of accuracy. In the event his activities become the subject of an inquiry, he will be judged by a record painstakingly constructed over a period of considerable time, involving, in retrospect, a picture of the market not available to him at the time he made the particular decision in question. Further, he will be judged by statutory experts, who perforce tread where others would be reluctant to break ground without more empirical data.[60]

A trader must have a delicate feel for a market situation. Under certain circumstances, an increase in the market price may stimulate demand because investors regard such increase as an indication that the price will go higher; under other circumstances, it may be a deterrent to further buying. He may be short in a security because he expects the price to go down, or he may be short in the security because he is unable to buy the security at his current bid price. He may sense the direction of the market, in which event he will follow one pattern; or he may feel that he does not know in which direction the market will move next, in which event he will follow another pattern.[61]

[60] Thus, without any empirical evidence in the record to support such conclusions, the Commission has concluded that each of the following is indicative of a controlled and dominated market: (1) to solicit sales while short in the security; (2) to sell short at increasingly higher prices despite a small floating supply; (3) consistently to maintain a large spread between bid and ask prices; (4) and to maintain a spread between bid and ask prices sufficient to permit covering a short position at a profit in a rising market. Sterling Sec. Co., Securities Exchange Act Release No. 6100, Nov. 2, 1959.

[61] In this situation, the dealer is likely to attempt to minimize his risk by having a wide spread between his bid and ask price. He does so, however, at his peril inasmuch as the Commission will regard a large spread as indicative of a controlled and dominated market. Sterling Sec. Co., Securities Exchange Act Release No. 6100, Nov. 2, 1959. A dealer not too eager to make an active market will also have a wide spread, as he is looking primarily for orders he can offset against each other.

IX

Conclusion

This article has attempted to analyze "control and domination" cases by isolating pertinent elements. We, indeed, may be in an area where the complete picture adds up to more than the sum of the isolated parts. Nonetheless, inasmuch as a great deal of the activity involved is characteristic of trading practices generally, it is imperative that the Commission face squarely the type of activity that it desires to condemn.

The security dealer needs a degree of latitude in trading that cannot be bounded by arbitrary restrictions. The ingenuity of the market manipulator, on the other hand, has undoubtedly made the Commission reluctant to confine itself to any narrow definition of "control and domination." Nonetheless, ground rules on certain fundamental questions of policy are badly needed, as a guide both to the dealer and also to the Commission in the drawing of intelligent inferences concerning the impact and purport of market activities.

The Commission's staff is rapidly moving, as we have seen, toward a position that raises serious problems for securities dealers making primary markets. Not only is the Commission, too, arriving at such a position, but unfortunately it is doing so in a manner that does not make clear the fact of and the reasons for this movement. Involved are policy problems having a widespread impact on the securities industry which are being resolved in administrative adjudication rather than through the exercise of the rule-making power. Although an administrative agency can, in effect, legislate by adjudication, despite the fact that a minority of the Supreme Court has characterized such practice as "administrative authoritarianism,"[62] an administrative agency, unlike a court, also has the rule-making power, and many would conclude that policy can more effectively and fairly evolve through use of this power. To legislate by administrative adjudication involves an element of retroactivity that, while lawful, imposes particular hardships on the litigants and is not designed as effectively to permit the presentation of all the factors so essential to informed policy formulation. The decisions being made in this area frequently involve respondents who are penny-stock dealers, financially irresponsible dealers, or generally disreputable dealers. Nonetheless, there cannot be a double standard of principles applicable to dealers, and the principles involved have real and substantial import for the respectable dealers as well.

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[62] SEC v. Chenery Corp., 332 U.S. 194, 216 (1947).

If the Commission were to approach the problem by rule-making, at least four tacks should be considered:

1. To provide that a dealer must disclose in all transactions (or at least all retail transactions) the fact that he is the principal (or only) market in a particular security. This is a disclosure approach.

2. To prohibit a dealer making a market in a security from also buying and selling the security on a retail level. This approach, in effect, substantially precludes a dealer from stimulating demand in a security being positioned by it.

3. To require a dealer to act only as agent in retail transactions involving a security in which he makes a principal market. This is somewhere between disclosure and absolute prohibition, requiring, in effect, completion of retail transactions through another dealer.[63]

4. To do nothing, relying on *Norris & Hirshberg* and section 9(4) of the Securities Exchange Act of 1934.

One of the principal issues to be resolved is the extent to which dealers are to be permitted to stimulate demand of a security in which they trade by the dissemination of information. Secondarily, customers are undoubtedly entitled to know that the dealer is the principal market, and hence that if the dealer voluntarily or otherwise discontinues trading in the security, there may not be a market for the security. Yet, realistically, it is doubtful whether such disclosure would have any substantial impact on trading decisions. In the last analysis, the only real protection to the investor may well be more effective policing of the representations being made in order to stimulate demand.

[63] This does not entirely eliminate the incentive for a manipulation, as evidenced by the many manipulation cases involving listed securities where this, in effect is required. See case cited *supra* note 24. Moreover, at least one over-the-counter manipulation case involved a broker-dealer effecting many transactions for customers as their agent. S. T. Jackson & Co., 36 S.E.C. 631, 652 (1950).