

Office Memorandum • SECURITIES AND EXCHANGE COMMISSION

DATE: September 18, 1961

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

FROM : Mr. W. J. Crow, Regional Administrator
Washington Regional Office

SUBJECT: H. J. Res. 438 (Investigation of Securities Market)

In compliance with Chairman William L. Cary's memorandum dated September 8, 1961, re: above subject, I, hereby submit my ideas and recommendations as to the areas to be covered by the inquiry under above H. J. Resolution 438, applicable to Over-the-Counter Markets.

I. (a) First I would like to discuss the registration of a B.D. There are no qualification requirements for a Broker-Dealer. Any one with \$500.00 or less can register as a Broker-Dealer, if he has no disqualification against him. I believe a person to qualify as a Broker-Dealer should have a specific number of years of experience with a reputable Broker-Dealer. A person to qualify to register to sell Real Estate is required to pass an examination and have certain experience. They sell real property that can be viewed by the buyer and he should know what he is buying. A Broker-Dealer selling stock certificates, a piece of paper, must explain properly what he is selling, and to me there is more requirement for experience, dependability and honesty on the part of the Broker-Dealer than on a Real Estate Broker.

Recommendation: I recommend that some experience requirements be set up for a Broker-Dealer, that must be met before the Commission will clear the registration of the Broker-Dealer.

(b) Sales-Representatives: Today all salesmen of securities must register only with the National Association of Securities Dealers, Inc., the Securities and Exchange Commission has no records of the salesmen registered with a Broker-Dealer.

Recommendation: I recommend that the Securities and Exchange Commission set up qualification, a proper examination for character and qualification, and registration of all sales-representatives with the Commission.

(1) Training for Sales Representatives. Some larger Broker-Dealer's, like Merrill Lynch, Pierce, Fenner & Smith, have an excellent training program for their sales-executives, however, very few of the other firms have adequate training programs. The over-the-counter Broker-Dealers do not have adequate training programs.

Memorandum to Mr. Philip A. Loomis, Jr.
Page Two

Recommendation: I recommend that we investigate the possibility of having the Exchanges set up a training program for all sales-representatives of their Member Firms. As to a training school for the sales-representatives of over-the-counter Broker-Dealers, I would suggest that the Broker-Dealers be required to contribute to a school for the proper training of sales-representatives. Perhaps the NASD would be interested in operating such a school, or the school could be operated by a College under contract. With requirements for such training of sales-representatives, supervision of their work should be easier by the Broker-Dealers.

(2) Some over-the-counter Broker-Dealers are not members of the NASD and their sales-representatives are not required to register with NASD or the Securities and Exchange Commission.

Recommendation: It is recommended that all Broker-Dealers be required to send their recommended sales-representatives to a training school and register them with the Securities and Exchange Commission, whether they are members of the NASD or not. The Broker-Dealers should all be required to contribute to the operation of the school. In this way the Securities and Exchange Commission would have some record of sales representatives of all Broker-Dealers.

(3) Broker-Dealers being registered by Sales-Representatives of closed Broker-Dealers. We have faced the problem of having some 12 to 14 new Broker-Dealers registered from sales-representatives of one firm, American Diversified Securities, Inc., after we closed them by Injunction. To stop their registration we were required to have evidence of violations, by the individuals who were registering, to initiate a denial proceedings within 30 days from the date of filing of the registration statement. It is impossible to have an investigation completed within 30 days of an operation as large as ADS. When the investigation is complete we probably will have grounds to revoke the registrations of some of the new Broker-Dealer.

Recommendation: It is my idea that some rule should be made effective to prevent any sales-representative from registering as a Broker-Dealer when he has been working for a Broker-Dealer who was closed by Injunction, pending the completion of the investigation. The 30-day rule should not be so rigid as to require proof of grounds to deny registration, we should be able to prove merely implication in violation to delay clearance of registration.

(4) Mutual Fund Salesmen: The Mutual Fund Salesmen are covered in the above recommendations. Our office has never had the same difficulties with Mutual Fund Salesmen as we have had with the Over-the-Counter Salesmen. The majority of the Broker-Dealers selling Mutual Funds are representatives of the Fund, the money going direct from the customer to the Fund, and the certificate being mailed direct to the customer by the Fund. Commissions are paid to the Broker-Dealer monthly.

II. Over-the-Counter, Distribution-Hot Issues.

(a) Most Hot Issues are registered under Regulation A, some as low as \$2.00 a share and in a very short time they reach \$12.00 to \$14.00. We make every effort to police these issues, but with our limited personnel we have difficulty in following up on all of them. The companies with the name of "Uranium" were the Hot Issues during 1955-56 and presently the companies with "tronics" added are the Hot Issue problems. The recent Regulation A's have been rather complicated by the claim of government contracts for Electronic equipment, and by the very poor job in preparation of the Regulation A filing. This requires time in writing long letters of comment and waiting for amendments delays the clearance of the filings.

(b) Underwriter disqualification - Selling Group Member. Where a Broker-Dealer has been Underwriter for a Regulation A which has been suspended, the Broker-Dealer is disqualified from acting as an Underwriter under Rule 252(e). The same Broker-Dealer can act as a Member of a Selling Group, under another Underwriter, and participate in the selling of an issue under Regulation A. It is a method of getting around our Rule 252(e). We have had several Broker-Dealers who have revocation proceedings pending against them and the Regulation A's for which they had acted as Underwriter were suspended, however, they continue to act as a Member of the Selling Group for other Underwriters. This to me is incongruous and should be corrected.

Recommendation: I suggest that a disqualification of a Broker-Dealer which prohibits his acting as an Underwriter should also disqualify the Broker-Dealer from participating in an Underwriting as a Member of the Selling Group.

(c) Use of red-herring Offering Circulars prior to clearance. We have experienced the use, by some Underwriters, as well as other Brokers of a red-herring Offering Circular prior to clearance of the Regulation A. It is understood that red-herrings are authorized in a Full Registration, however, I do not believe the red-herring should be authorized under the Regulation A exemption. It is also understood that findings of interest are authorized in a Full Registration, however, we have found evidence of some Underwriters having found interest, accepted money for shares, and having a complete list of customers for almost twice the number of shares to be sold under the Regulation A. This would aid in holding down the Hot Issue problem and the problem should be clarified as soon as possible.

Recommendation: I believe that a Rule should be approved prohibiting the use of a Red Herring Offering Circular or the Finding of Interest among customers prior to the clearance of the Regulation A. This is the perfect example of a Hot Issue and the case mentioned above was a case where the issue rose quite rapidly because of the unusual interest in the issue and it was sold out the day it was cleared.

(d) Reporting Under Regulation A. At the present time the only report required of an Issuer under Regulation A, is the 2-A Report that must be filed every 6 months from the date of clearance of the Regulation A. This report merely shows the number of shares sold during the past 6 months, the amount of money received, the number of shares still being offered, the way the money has been used, and the names of Members of the Selling Group. The issuer is not required to file any financial reports, except in the filing of the original statement or 1-A. We have many inquiries from stockholders of issuers under Regulation A, who have attempted to get information from their issuer and have their letters returned unclaimed. Reports required from the issuers of their financial condition each 6 months, would give the Securities and Exchange Commission information of the failure of the company to pass on to the stockholders.

Recommendation: That all issuers under Regulation A be required to furnish reports each 6-months, or yearly, showing the financial progress of the company. This would be similar to the reports required under the full registration, 8K or 10K reports. All issuers under Regulation A should be required to give annual reports to stockholders regardless of the state of incorporation requirements.

(e) Control of Finders - Under some Regulation A's and particularly in some Hot Issues, we have found some finders requiring the issue of as high as 35,000 shares to him in order to get an Underwriter for their Regulation A. I have also found one Finder using a letter to companies, recommending that they "Go Public and sell \$100,000.00, \$500,000.00 or \$1,000,000.00 worth of stock without any responsibility to pay dividends or to repay the money to the stockholders." I might say the letter has been changed in this respect, at my suggestion and the new letter does show a responsibility to the stockholders. This finder is paid in stock by the underwriters and whether the stock is registered or not is questionable.

Recommendation: That some investigation be made to determine whether Finders should be controlled by the Securities and Exchange Commission.

(f) Factors - In our ADS case we have found an over-the-counter Broker-Dealer using a Factor to handle large purchases of securities for the Broker-Dealer. The Factor is used by Member Houses but this is our first experience with an over-the-counter Broker-Dealer using the Factor. The Broker-Dealer is now Bankrupt.

Recommendation: That inquiry be made to determine whether the over-the-counter Broker-Dealers should be required to report the use of a Factor, or whether the use of the Factor should be prohibited by an over-the-counter Broker-Dealer.

III. (a) Use of Nominees - By Issuer or Underwriter. We have recently discovered a prevalent use of Nominees by issuers in the issue of stock before the filing of a Regulation A. We have found the use of "Pocket Book Corporation," a corporation incorporated for the purpose of preventing the disclosure of the names of individuals who have received stock from the issuer. In our filing, we require the disclosure of the names of the people involved in the Corporation and found that there were 9 officers, directors and salesmen of the Underwriter, the corporation being formed merely for the purpose of preventing the disclosure of the names of the individuals who had loaned money and who were to receive stock.

Recommended: That Regulation A rules be clarified to prohibit the use of nominees in the filing. Use of nominees, such as a Corporation, to hide the number of persons involved in some cases cause a violation of Section 5, because the Section (4) 1 exemption may not be available.

(b) The use of nominees by placing securities in several individuals names, without their knowledge, has been developed in a number of our cases. After the Regulation A has been sold, the 2-A is filed and the shares are then sold to aid in manipulating the market upward. This, of course, is a violation of Regulation A because the issue had not been completely distributed to the Public. We recently had a filing in which it was disclosed that only 14 had received stock, however, after investigation we found that some 130 persons had actually received stock from nominees. The Regulation A was suspended and an Injunction filed against the issuer, officers and other promoting persons who received stock.

Recommendation: Same as in III (a).

IV. Proxy fights by Over-the-Counter Issuers. We have experienced quite a proxy battle for control of an Issuer, Politronics Research, Inc., by a number of stockholders who were attempting to oust the control persons from control of the Corporation. No reports were required to be filed with the Securities and Exchange Commission, however, one side in the battle forwarded to us copies of literature used in the fight for control. The issuer had filed a Regulation A with the Securities and Exchange Commission. The stockholders failed in the proxy battle.

Recommend that a study be made as to the possibility of requiring reports to the Securities and Exchange Commission when a Proxy fight develops, similar to Proxy reports for Issuers filing a full registration.

V. Requirements of Report - Sales under Exemption.

(a) Section 3A-11, Intrastate - The Commission has no knowledge of issuers selling stock under this exemption. I believe that the Securities and

Exchange Commission should receive a copy of reports required by the State Commission, when the State authorizes the sale of an intrastate offering. Some people have recommended elimination of the Section 3All exemption, however, I do not recommend it. In the State of Pennsylvania alone, our office would receive a possible 500 to 600 Regulation A filings in each two month period and it would be impossible for us to process them.

(b) Section 4(1) There is no requirement for reporting sales under this exemption.

(c) We receive many calls from honest and upright Broker-Dealers inquiring as to whether a block of X-stock can be sold. After checking the records of the Commission we find no record of registration by the issuer, so we can only tell the Broker-Dealer that we have no information at the Commission. If he sells, he does it at his own risk. Brokers have requested that we require that all securities sold under an exemption be stamped with a statement showing the exemption claimed. This would be a warning to the Broker as well as to the Transfer Agent. Objection has been raised that stamping the securities of an Honest Officer of an issuer would not be fair to the officer. I do not believe an Honest Person would object to the stamping, if it would prevent Dishonest persons from attempting to sell the securities illegally.

Recommendation: That the issuers be required to stamp all securities with a statement showing the exemption under which the securities were sold, such as, "Sold under Section 3All exemption, not to be resold except to residents of the State of _____" or "Sold under Section 4(1) Private Sale held for Investment," or the proper statement. Some Issuers do stamp certificates.

VI. Transfer Agent Control. A transfer agent is so closely connected to the transaction in the sale of securities, the question of regulation and control has always been given serious thought by me. We have experienced the setting up of a transfer agent by questionable persons in our Region and it is believed that it is firmly under the control of a revoked Broker-Dealer and one who has an injunction against him. The Securities and Exchange Commission does not have any control over the transfer agent.

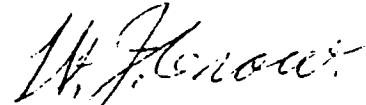
Recommendation: That transfer agents be required to register with the Securities and Exchange Commission showing the persons connected with the firm. Rules should be set up to control the operation of the transfer agent, because transfer agents can under certain conditions prevent violations of the Securities and Exchange Laws by refusing to transfer securities sold illegally. Uncontrolled transfer agents have no obligation to aid in the prevention of illegal transfers of securities.

VII. I appreciate that some of the above suggestions will require additional personnel in the Commission to handle the additional registrations

Memorandum to Mr. Philip A. Loomis, Jr.
Page Seven

and reports required. The recommendations are made for the purpose of raising questions in the Over-the-Counter Market that could be included in the investigation authorized by the Congress under H. J. R. 438. There are no doubt many, many more points to be covered by the investigation.

Respectfully submitted:

A handwritten signature in cursive script, appearing to read "W. J. Crow".

W. J. Crow
Regional Administrator