

# LEGAL REGULATION OF OVER-THE-COUNTER MARKET MANIPULATION: CRITIQUE AND PROPOSAL

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## INTRODUCTION

The securities industry has undergone fundamental changes in recent years.<sup>1</sup> One of the most important developments has been the increased investment activity by large institutions.<sup>2</sup> Starting in the early 1960's, the rising volume of institutional trading began to alter significantly the character of the securities markets.<sup>3</sup> The growth in

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1. See SEC, POLICY STATEMENT, FUTURE STRUCTURE OF THE SECURITIES MARKETS, CCH FED. SEC. L. REP. No. 409 (Feb. 4, 1972), reprinted in 4 SECURITIES L. REV. 473 (1972); 1 INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 64, 92d Cong., 1st Sess. xxii-xxv (1971) [hereinafter cited as INSTITUTIONAL INVESTOR STUDY]; Cary & Werner, *Outlook for Securities Markets*, 49 HARV. BUS. REV. No. 4 at 16 (July-Aug., 1971), reprinted in Hearings on H.R. 5050 and H.R. 340 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 93d Cong., 1st Sess., pt. 1, at 212 (1973) [hereinafter cited as Hearings on Securities Exchange Act Amendments of 1973].

2. See Address by Manuel F. Cohen before the Bankers Association, Mid-Winter Trust Conference, New York, Feb. 11, 1969, in R. JENNINGS & H. MARSH, SECURITIES REGULATION 18 (3d ed. 1972); S. ROBBINS, THE SECURITIES MARKETS 215-43 (1966). The most important institutional investors are banks, insurance companies, mutual funds, employee pension and welfare funds, and foundation and college endowments. In authorizing the INSTITUTIONAL INVESTOR STUDY, *supra* note 1, Congress directed the Securities Exchange Commission [hereinafter referred to as the "SEC" or "Commission"] to focus especially on these major investors. Securities Exchange Act of 1934, § 19(e)(1), 15 U.S.C. § 78s(e)(1)(1970). See also Solomon, *Institutional Investors: Stock Market Impact and Corporate Control*, 42 GEO. WASH. L. REV. 761 (1974).

3. During the 1960's institutions assumed the dominant position in the stock market. From 35 percent of total trading in 1963 and 47 percent in 1966, they now account for at least 70 percent of public volume. At the same time institutional volume rose, the relative share of individual activity declined. . . .

This shift to institutional dominance in so short a period of time has changed the character of markets, biased their valuation function, affected their liquidity—which shows especially in down markets—and complicated corporate financial decisionmaking.

Statement of John C. Whitehead, Chairman, Securities Industry Association, Hearings on H.R. 5050 and H.R. 340 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 93d Cong., 1st Sess., ser. 93-51, pt. 2, at 655 (1974).

importance of regional exchanges<sup>4</sup> and the development of the "third" and "fourth" markets<sup>5</sup> stemmed in large part from the collision of the economic power and interests of the institutions with the restrictive membership and commission rules of the New York Stock Exchange. Accompanying the shift to institutional dominance of the marketplace was the growing awareness that existing trading mechanisms were often unable to handle satisfactorily transactions involving large institutional-sized blocks of stock.<sup>6</sup> The trading boom in the

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4. New York Stock Exchange members are permitted to trade in NYSE-listed securities on a regional exchange, provided the NYSE member is also a member of the regional exchange and the particular securities are listed or traded there. The Rules of the New York Stock Exchange, 10 S.E.C. 270 (1941). The increasing importance of regional exchanges has resulted primarily from the opportunity they afforded to NYSE members to trade in NYSE-listed securities free of certain restrictive NYSE rules, particularly the fixed commission rate structure and the prohibition of splitting commissions. SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY REPORT, 93d Cong., 1st Sess. CCH FED. SEC. L. REP. No. 466 (1973) [hereinafter cited as SENATE SECURITIES INDUSTRY STUDY REPORT]. Of course, these factors are considerably less important due to the introduction of negotiated commission rates. Another factor accounting for the increased importance of regional exchanges was the membership granted by certain regional exchanges to subsidiaries of institutional investors. See SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES INDUSTRY STUDY REPORT, 92d Cong., 2d Sess. CCH FED. SEC. L. REP. No. 438 at 118 (1972) [hereinafter cited as HOUSE SECURITIES INDUSTRY STUDY REPORT]; SENATE SECURITIES INDUSTRY STUDY REPORT, *supra* at 71-73. SEC rule 19b-2, 17 C.F.R. § 240.19b-2 (1975), established uniform standards for institutional membership. The rule requires all registered exchanges to adopt rules requiring that a member "have as the principal purpose of its membership the conduct of a public securities business" and transact at least 80 percent of the volume of its exchange securities transactions with public customers. *Id.* See 39 SEC ANN. REP. 8-9 (1973).

5. The term "third market" refers to over-the-counter (OTC) transactions in exchange-listed securities. Although the third market is a component of the OTC market, it is viewed as a distinct entity because of its dependence on exchange prices. See SEC, REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2, 870-911 (1963) [hereinafter cited as SPECIAL STUDY]; Abdo, *The Third Market*, 76 COM. L.J. 105 (1971); Polakoff & Sametz, *The Third Market—The Nature of Competition in the Market for Listed Securities Traded Off-Board*, 11 ANTITRUST BULL. 191 (1966); Schlesinger, *The Third Market—Challenge to the New York Stock Exchange*, 20 SW. L.J. 640 (1966).

"Fourth market" transactions are those involving securities traded directly among institutions. The importance of fourth market activity is difficult to evaluate because of the lack of statistical information on these transactions. See S. ROBBINS, THE SECURITIES MARKETS 257-61 (1966). The INSTITUTIONAL INVESTOR STUDY, *supra* note 1, vol. 4, at 1824, concluded that fourth market trading is not presently a significant factor in the securities industry.

6. See Fiske, *Can the Specialist System Cope with the Age of Block Trading?*, 2 SECURITIES L. REV. 599 (1970).

The availability of the NYSE, the regional exchanges, and the third market for trading in particular securities has exacerbated the difficulties involved in institutional transactions. With several available markets operating concurrently, the demand for a particular security on any one market is reduced, since the total demand is no longer concentrated in one trading center. An institution desiring to sell a large block of

late 1960's,<sup>7</sup> followed shortly by a sharp decline in volume,<sup>8</sup> caused major back-office administrative and financial problems for brokerage firms,<sup>9</sup> which in turn provoked demands for increased investor protection<sup>10</sup> and simplification of the mechanics of the trading pro-

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securities will therefore be less likely to complete the transaction on one exchange without suffering a price reduction due to fragmented demand. See HOUSE SECURITIES INDUSTRY STUDY REPORT, *supra* note 4, at 117-19.

Institutional trading has been facilitated by the emergence of "block positioners," broker-dealers who purchase a substantial amount of stock offered by an institution for their principal accounts with a view to later resale. Like the stock exchange specialist, one of the primary roles of the block positioner is to facilitate transactions when there is a temporary imbalance of supply and demand for a security.

Block positioners sometimes assume part of the market-making function when the NYSE specialist is not given the opportunity, is unable or decides not to do so. . . . [T]he participation rate of the block [positioner] varies inversely with the participation rate of the specialist. The combined participation rate of the two is somewhat greater in the stocks of those specialists units that participate in their markets in depth than in the stocks of those that do not.

INSTITUTIONAL INVESTOR STUDY, *supra* note 1, vol. 4, at 1601-02.

7. Share volume on all national and regional securities exchanges increased from 1,874,718,000 shares traded in 1963 to 5,406,582,000 shares traded in 1968. Dollar volume increased during the same period from approximately \$64 billion to \$197 billion. 40 SEC ANN. REP. 159 (1974). There was also a substantial increase in volume in OTC trading of stocks listed on national securities exchanges. *Id.* at 161.

8. Share volume on all national and regional securities exchanges decreased from 5,406,582,000 shares traded in 1968 to 4,834,523,000 shares traded in 1970. Dollar volume of shares traded on national securities exchanges, however, decreased in the same period from approximately \$197 billion to \$132 billion. *Id.* at 159 (1974). See HOUSE SECURITIES INDUSTRY STUDY REPORT, *supra* note 4, at 9-12.

9. See SENATE SECURITIES INDUSTRY STUDY REPORT, *supra* note 4, at 28-29; HOUSE SECURITIES INDUSTRY STUDY REPORT, *supra* note 4, at 3-12; SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES in [Special Studies Transfer Binder] CCH FED. SEC. L. REP. ¶ 74,801, at 65,501 (Dec. 28, 1971); Painter, *An Analysis of Recent Proposals For Reform of Federal Securities Legislation*, 71 MICH. L. REV. 1576, 1578-82 (1973).

The most critical problem confronting the industry was the inability of firms to cope with their bookkeeping and paperwork volume, which in turn fostered the more specific problems of (1) the currency and accuracy of records and the concomitant questions as to the validity of securities positions, ownership and location of certificates and dividends and the resultant unreliability of financial statements; (2) prompt delivery of securities owed to other broker-dealers and customers; (3) loss and/or theft of securities; (4) increased costs of operations to correct errors, make redeliveries, process customer complaints, prepare reports to regulatory agencies, etc.

Statement of the National Association of Securities Dealers, Inc., *Hearings on the Securities Industry Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 1st Sess., pt. 1, at 37 (1971) [hereinafter cited as 1971 House Hearings].

10. Demands for increased investor protection did not go unheeded. The Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (1970), provided for the establishment of the Securities Investor Protection Corporation, *id.* § 78ccc, and for insurance of customer accounts up to a maximum of \$50,000. *Id.* § 78eee(f)(1). See SECURITIES INVESTOR PROTECTION CORPORATION, A HISTORY AND EXPLANATION OF OPERATIONS (1975); Note, *The Securities Investor Protection Act of 1970: An Early*

cess.<sup>11</sup> Another development, which may ultimately prove to have the most pervasive impact on the structure of the securities markets, is the emergence of sophisticated communications and data processing facilities designed to increase the information available to brokers, dealers, and investors.<sup>12</sup>

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*Assessment*, 73 COLUM. L. REV. 802 (1973). The SEC also strengthened its regulation of broker-dealers. See SEC rule 15c3-3, 17 C.F.R. § 240.15c3-3 (1975); Painter, *An Analysis of Recent Proposals for Reform of Federal Securities Legislation*, 71 Mich. L. Rev. 1576, 1584-96 (1973).

11. The Senate version of the Securities Processing Act of 1973, S. 2058, 93d Cong., 1st Sess. § 5 (1973), directed the SEC to revise security settlement and clearance procedures in order to eliminate "the stock certificate as a means of settlement among brokers or dealers of transactions consummated on national securities exchanges or by means of mails or other means or instrumentalities of interstate commerce." SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, REPORT TO ACCOMPANY S. REP. NO. 93-359, 93d Cong., 1st Sess. 54 (1973). A recent amendment to the Securities Exchange Act of 1934 provides:

The Commission shall use its authority under this chapter to end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities consummated by means of the mails or any means or instrumentalities of interstate commerce.

Securities Acts Amendments of 1975 § 15, codified at 15 U.S.C.A. § 78q-1(e) (Supp. IV, 1975), amending Securities Exchange Act of 1934 § 17, 15 U.S.C. § 78q (1970).

12. See SPECIAL STUDY, *supra* note 5, pt. 2, at 351-58, 655-59. The importance of automated information processing to OTC markets was highlighted:

The relevance of automation to standards of performance and conduct and to the quality of over-the-counter markets generally is the point of ultimate significance. Despite inertia or even resistance, the industry must ultimately take advantage of technological progress where considerations of efficiency and economy so dictate, as in any other field of endeavor. On the other hand, the potential of automation is quite obviously a potential for removing or alleviating some of the fundamental problems and limitations that have historically characterized both the operation and the regulation of over-the-counter markets. Thus both business interest and public interest point to the need for constant attention and effort toward realization of this potential.

*Id.* at 658-59.

Some of this potential has already been realized by the establishment of the National Association of Securities Dealers Automated Quotation system (NASDAQ), which became operational on Feb. 8, 1971. 37 SEC ANN. REP. 8-10 (1971); NATIONAL ASSOCIATION OF SECURITIES DEALERS, 1970 REPORT TO MEMBERS 11-13; Katz, *National Association of Securities Dealers Automated Quotation System*, THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION (R. Mundheim & A. Fleischer eds. 1972). It appears likely that the securities markets of the future will consist primarily of elaborate communications networks. This approach stems from the congressional finding expressed in the Securities Acts Amendments of 1975 that new "data processing and communications techniques create the opportunity for more efficient and effective market operations." Securities Acts Amendments of 1975 § 7, codified at 15 U.S.C.A. § 78k-1(a) (Supp. IV, 1975), amending Securities Exchange Act of 1934 § 11, 15 U.S.C. § 78(k) (1970). More specifically, Congress expressed its finding that

[t]he linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

These economic and operational developments have led to a thorough reevaluation of the securities industry, resulting in a number of important studies<sup>13</sup> and proposals.<sup>14</sup> Together with specific concerns expressed by interest groups<sup>15</sup> in the industry, this general reappraisal culminated recently in the enactment of the Securities Acts Amendments of 1975.<sup>16</sup> These amendments effect the most significant changes in the institutional and regulatory structures of the securities industry since the Securities Exchange Act was adopted in 1934.<sup>17</sup> Although the Reform Act alters dramatically the environment for securities trading as a whole, it focuses primarily on the established national exchange markets. The over-the-counter (OTC) market<sup>18</sup>

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*Id.* In accordance with these findings, the SEC has been directed "to facilitate the establishment of a national market system for securities." *Id.* The national market system is envisioned as a "system of communications by which the various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together." SEC POLICY STATEMENT, FUTURE STRUCTURE OF THE SECURITIES MARKETS, CCH FED. SEC. L. REP. No. 409, at 8 (Feb. 4, 1972), reprinted in 4 SECURITIES L. REV. 473, 477 (1972). See generally SEC POLICY STATEMENT ON A CENTRAL MARKET SYSTEM, CCH FED. SEC. L. REP. No. 473 (Apr. 2, 1973); SEC ADVISORY COMMITTEE REPORT ON A CENTRAL MARKET SYSTEM, CCH FED. SEC. L. REP. No. 469 (Mar. 9, 1973).

13. SENATE SECURITIES INDUSTRY STUDY REPORT, *supra* note 4; HOUSE SECURITIES INDUSTRY STUDY REPORT, *supra* note 4; SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES, H.R. Doc. No. 90-231, 92d Cong., 1st Sess. (1971), in [Special Studies Transfer Binder] CCH FED. SEC. L. REP. ¶ 74,801 (Dec. 28, 1971). INSTITUTIONAL INVESTOR STUDY, *supra* note 1. See generally Note, *Federal Legislation to Enhance Competition in the Securities Industry*, 16 WM. & MARY L. REV. 621, 639-56 (1975).

14. SEC, POLICY STATEMENT ON A CENTRAL MARKET SYSTEM, CCH FED. SEC. L. REP. No. 473, pt. II (Apr. 2, 1973); SEC, ADVISORY COMMITTEE REPORT ON A CENTRAL MARKET SYSTEM, CCH FED. SEC. L. REP. No. 469 (Mar. 9, 1973); SEC, POLICY STATEMENT ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS, in [Special Studies Transfer Binder] CCH FED. SEC. L. REP. ¶ 74,811 (Feb. 2, 1972); W. MARTIN, THE SECURITIES MARKETS, in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,184 (Aug. 5, 1971).

15. The national and regional exchanges, the National Association of Securities Dealers, the Securities Industry Association, broker-dealer firms, institutional investors, and many other groups participated in the congressional study hearings. See 1971 House Hearings, *supra* note 9, *passim*.

16. Securities Acts Amendments of 1975 §§ 2-31, codified at 15 U.S.C.A. §§ 78a-kk (Supp. IV, 1975), amending Securities Exchange Act of 1934 §§ 1-34, 15 U.S.C. §§ 78a-kk (1970) [hereinafter "Securities Reform Act" or "Reform Act"].

17. CCH FED. SEC. L. REP. No. 589, at 2 (Jun. 4, 1975). Fundamental legal changes had already taken place prior to enactment of the Securities Reform Act of 1975 as a result of private litigation, see, e.g., Silver v. New York Stock Exchange, 373 U.S. 341 (1963); Thill Securities Corp. v. New York Stock Exchange, 433 F.2d 264 (7th Cir. 1970), cert. denied, 401 U.S. 994 (1971); Note, *Fixed Brokerage Commissions: An Antitrust Analysis After the Introduction of Competitive Rates on Trades Exceeding \$500,000*, 85 HARV. L. REV. 794 (1972); administrative activity, see, e.g., SEC rule 19b-2, 17 C.F.R. § 240.19b-2 (1975); SEC rule 19b-3, 17 C.F.R. § 240.19b-3 (1975); Note, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 YALE L.J. 811 (1971); and congressional legislation, see, e.g., Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (1970).

18. The term "over-the-counter market" encompasses all transactions in securities not taking place on a national or regional exchange. SPECIAL STUDY, *supra* note 5, pt.

and its particular problems have not received the attention necessary either to ensure a free, competitive, and open trading environment or to provide adequate protection of the investor from illegal trading practices.<sup>19</sup>

OTC markets serve as vehicles for both the distribution and trading of securities.<sup>20</sup> By offering corporations access to capital through the distribution of their securities to the investing public,<sup>21</sup> by providing some degree of liquidity to holders of securities which are not admitted to trading on securities exchanges,<sup>22</sup> and by making avail-

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2, at 541. An essential characteristic of the OTC market is the interdealer quotation system, as described below:

[A]n over-the-counter market is reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations . . . by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

Treas. Reg. § 1.453-3(d)(4)(1958).

19. The relative neglect of the abuses and problems associated with OTC markets, in contrast to the extensive attention paid to trading practices on the exchanges, stems in large part from the elusive nature of the OTC market system—a constantly changing kaleidoscope of dealers and securities about which information is difficult to obtain. For general descriptions of the OTC markets, see SPECIAL STUDY, *supra* note 5, pt. 2, at 546-53; I. FRIEND, G. HOFFMAN & W. WINN, THE OVER-THE-COUNTER SECURITIES MARKETS 41-105 (1958). With the introduction of the NASDAQ system, see note 12 *supra*, and the adoption by the SEC of reporting requirements applicable to third market transactions, SEC rule 17a-15, 17 C.F.R. § 240.17a-15 (1975), information about OTC markets is now more readily available.

Although the problems of the OTC markets have received only scant attention in legal commentary, there are a number of recent articles providing excellent discussions of the general framework and selected problems in this area. E.g., Bloomenthal, *Market-Makers, Manipulators and Shell Games*, 45 ST. JOHN'S L. REV. 597 (1971) [hereinafter cited as *Market-Makers, Manipulators and Shell Games*]; Eadington, *Regulation of Over-the-Counter Markups: A Reappraisal of Present Policy*, 1 LOYOLA L. REV. 128 (1968); Martin, *Broker-Dealer Manipulation of the Over-the-Counter Market—Toward a Reasonable Basis for Quotations*, 25 BUS. L. 1463 (1970). Commentaries addressed generally to market restructuring occasionally make cursory reference to OTC markets. E.g., Wolfson, Rosenblum & Russo, *The Securities Markets: An Overview*, 16 HOW. L.J. 791, 821-23 (1971). The most thoroughly treated aspect of OTC markets appears to be the particular problems encountered in securities distributions on OTC markets. See text accompanying notes 109-34 *infra*.

20. SPECIAL STUDY, *supra* note 5, pt. 2, at 546.

21. See I. FRIEND, J. LONGSTREET, M. MENDELSON, E. MILLER & A. HESS, INVESTMENT BANKING AND THE NEW ISSUES MARKET 4 (1967).

22. Because the stock exchanges impose minimum standards with respect to both the issuer and the value and distribution of the securities sought to be listed, the OTC market provides the only mechanism for the public trading of many smaller corporations. In this respect, the OTC market is essential to provide a degree of liquidity for investors in small corporations.

[I]n addition to a primary distribution network, we need the assurance of a broad secondary market—the trading market. The reason, of course, is to provide maximum liquidity to encourage primary investment. To over-

able a means for trading listed securities free from the restrictions imposed by the securities exchanges, OTC markets now play a vital role in corporate finance. In addition, OTC markets provide the principal mechanism for trading the securities of many small developmental companies and local business concerns which cannot meet the listing requirements of the securities exchanges. Moreover, the organization of trading activities on OTC markets, which differs in several important respects from the trading activities on exchange markets, makes OTC markets preferable for certain types of transactions.<sup>23</sup> OTC markets are, therefore, far too important a part of the securities industry to be neglected in this period of general review and restructuring.

OTC markets neither enjoy nor merit the same level of confidence on the part of investors as do the securities exchanges. The principal area of concern is the method by which prices are determined and the susceptibility of the price-setting process to abuse by dealers.<sup>24</sup> The

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simplify, you can't persuade people to come in unless they know they can get out.

Statement of Frank A. Hutson, Jr., Secretary and General Attorney, American Telephone & Telegraph Co., in Panel Discussion, *The Significance of Change in the Markets for Corporations*, 29 Bus. L.W. 73, 77 (Special Issue, March, 1974). See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 282-87 (1932).

23. [T]he variability in the inflow of orders and the presence of considerable block trading are better accommodated in the over-the-counter market. . . . [T]he over-the-counter market's real virtue is its emphasis on negotiation. In contrast to the specialist, the over-the-counter dealer is not required to act passively, waiting for incoming orders to provide him with opportunities to make inventory adjustments. Nor is he faced with having to take a position if he cannot match up a buyer and a seller. Instead, the over-the-counter dealer is free to communicate with potential buyers and sellers and, in general, to "shop" a deal aggressively. For this very reason, the over-the-counter dealer can do a better job than an exchange specialist in making a market for stocks having order flows that are thin or unbalanced.

R. WEST & S. TINIC, *THE ECONOMICS OF THE STOCK MARKET* 59-60 (1971).

24. There are a number of other serious problems concerning OTC markets which this Article does not address. One concern is the problem of investment liquidity. An OTC market for a particular security functions only when there are bona fide bids and offers for that security. I. FRIEND, G. HOFFMAN & W. WINN, *THE OVER-THE-COUNTER SECURITIES MARKETS* 43 (1958). OTC markets fade in and out of active operation depending on when dealers commence and terminate market making activities. In contrast to exchange specialists, OTC market makers are not registered as market makers in any particular security and are under no obligation to commence or maintain a market in any security. Moreover, even if there is an apparent market for a security, as evidenced by bids and offers submitted to an interdealer quotation system, such bids and offers may not turn out to be "firm" when an execution is sought. The National Association of Securities Dealers (NASD) has recently proposed an amendment to its by-laws that would require NASDAQ market makers to commit themselves to at least 90 days of continuous quotations once a market maker registered in a NASDAQ security. 25 NASD NEWSLETTER No. 1, at 3 (Apr., 1975). The NASD Board of Governors has also formulated a policy statement pursuant to the NASD Rules of Fair Practice that requires a dealer quoting a market in a security to purchase or sell at least one trading unit (generally 100 shares) at the quoted price. *Policy With Respect*

key figure in OTC transactions is the market maker,<sup>25</sup> a dealer who indicates that he stands ready to buy or sell securities for his own account at prices that he quotes. The quoted prices of OTC securities are usually determined by the interaction of market makers who negotiate among themselves by submitting and withdrawing purchase bids and offers to sell. There may also be interdealer bargaining with respect to particular transactions. Competition among market makers will generally ensure that an approximate correlation exists between the negotiated prices and the market values of the traded securities as determined by the forces of supply and demand. A decrease in the number of independent market makers or a concentration of trading in the hands of one particular dealer, however, diminishes actual competition and leads to a situation in which the price of a security can be manipulated. Since many issues traded on OTC markets have characteristics which make it probable that dealer-dominated markets will develop,<sup>26</sup> manipulation is a recurring problem.

The typical OTC manipulation arises when a dealer seeks to in-

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*to Firmness of Quotations*, CCH NASD MANUAL ¶ 2156 (1971). The NASD By-laws, moreover, require that each quotation entered must be reasonably related to the prevailing market. NASD BY-LAWS art. XVI, § 3, D(I)(C)(3)(b) (1973). The aggregate effect of these recent developments in the NASD self-regulatory framework represents a tentative first step toward assuring the existence of more reliable markets for securities traded OTC.

Another major problem is the conflict of interest predicament that may arise when an OTC market maker also deals with public customers. This situation occurs when the market maker is trying to dispose of a large block of stock, attempting to generate activity in a thinly traded stock, or promoting an unseasoned security. Under these circumstances, it is not surprising that market makers tend to be more aggressive in their merchandising techniques, often resorting to misrepresentations and to questionable selling practices. *See Market-Makers, Manipulators and Shell Games*, *supra* note 19, at 605-13. One solution to the problem is to require broker-dealers who are acting simultaneously as market makers in particular securities to disclose their dual capacity. *See Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). Another approach is simply to prohibit the same person from acting as both broker and dealer in a particular security. The Securities Reform Act of 1975 has sanctioned this approach by enabling the SEC to adopt rules designed to prohibit a dealer in a security from acting as a broker in that security. Securities Acts Amendments of 1975 § 11, codified at 15 U.S.C.A. § 78o-(c)(5) (Supp. IV, 1975), amending Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (1970).

25. The term "market maker" shall mean a dealer who, with respect to a particular security, holds himself out (by entering indications of interest in purchasing and selling in an interdealer quotations system or otherwise) as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange.

SEC rule 17a-9(f)(1), 17 C.F.R. § 240.17a-9(f)(1) (1975).

For a good description of the market maker's activities, see Bloomenthal, *The Case of the Subtle Motive and the Delicate Art—Control and Domination in the Over-the-Counter Securities Markets*, 1960 DUKE L.J. 196, 200-05.

26. See text accompanying notes 194-202 *infra*.

crease artificially the price of a particular security.<sup>27</sup> The means usually employed involve the distortion of the actual supply and apparent demand for the security. The manipulating dealer or cooperating dealer will purchase the security on the market, steadily increasing the inventory of the stock held in principal or agency accounts. By acquiring control over large quantities of the security, the dealer can effectively reduce the supply of the stock available for trading on the market; the decreased supply will generally lead to a higher price.<sup>28</sup> At the same time, the manipulating dealer increases apparent demand for the security by creating the impression of greater trading activity by his own purchases of the security for inventory. In addition, the dealer or cooperating dealers can systematically increase price quotations in the National Daily Quotation Service listings or through the National Association of Securities Dealers Automated Quotation system (NASDAQ),<sup>29</sup> leading other dealers and investors to believe that the actual selling price of the security is rising due to legitimate market activity.<sup>30</sup> Because few, if any,

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27. A dealer may want to induce an artificial increase in the price of a security to facilitate a distribution, SEC v. Cooper, 402 F. Supp. 516 (S.D.N.Y. 1975); SEC v. Rega, [Current] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975); SEC v. Resch-Cassin & Co., 362 F. Supp. 964 (S.D.N.Y. 1973), to sell accumulated inventory at inflated prices, SEC v. D'Onofrio, [Current] CCH FED. SEC. L. REP. ¶ 95,201 (S.D.N.Y. 1975); Bruns, Nordeman & Co., 40 S.E.C. 652 (1961); Gob Shops of America, Inc., 39 S.E.C. 92 (1959), to make the security more attractive as collateral for a bank loan, Franklin National Bank v. L.B. Meadows & Co., 318 F. Supp. 1339 (E.D.N.Y. 1970), to facilitate the sale of unregistered securities, SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); or to induce warrant holders to exercise options, Collins Securities Corp., SEC Securities Exchange Act Release No. 11766, (Oct. 23, 1975), [Current] CCH FED. SEC. L. REP. ¶ 80,327.

28. See, e.g., R.L. Emacio & Co., 35 S.E.C. 191 (1953):

[R]egistrant's extensive and concentrated buying program contracted the floating supply of the Silver Crescent stock, generally an essential ingredient in a plan to raise and maintain the price of a security.

*Id.* at 195. See Halsey, Stuart & Co., 30 S.E.C. 106 (1949). For further discussion of the manipulative effect created by drying up the supply of a security, see text accompanying notes 180-189 *infra*.

29. The National Daily Quotation Service is a private interdealer publication in which OTC brokers and dealers report daily bid and asked quotations for the securities in which they are dealing. The NASDAQ system is a computerized network enabling brokers and dealers to disseminate their bid and asked quotes and other trading information instantly. Both means of reporting quotations are essential to trading operations in the OTC market system. For further discussion of the National Daily Quotation Service and NASDAQ, see notes 165-66 *infra*.

30. "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, and tends to support the price at its inflated level." Gob Shops of America, Inc., 39 S.E.C. 92, 101 (1959). Other manipulation cases involving bid-raising schemes include SEC v. Resch-Cassin & Co., 362 F. Supp. 964 (S.D.N.Y. 1973); R.L. Emacio & Co., 35 S.E.C. 191 (1953); Adams & Co., 33 S.E.C. 444 (1952); Halsey, Stuart & Co., 30 S.E.C. 106 (1949); M.S. Wein & Co., 23 S.E.C. 735 (1946); Masland, Femon & Anderson, 9 S.E.C. 338 (1941); Barrett & Co., 9 S.E.C. 319 (1941).

actual sales need accompany the increasingly higher quotations, the appearance of an active, rising market created by the dealer's use of the quotation sheets or NASDAQ system is an illusion. Nevertheless, other dealers may increase their bid prices beyond levels warranted by real demand, believing mistakenly that the rising quotations in the security represent an active, independent market for the security. Thus, by decreasing the actual supply of the security and creating an appearance of increased demand,<sup>31</sup> the manipulator can cause significant price increases in the OTC security. When he ultimately disposes of his accumulated inventory at the manipulated price, the market will recede to its normal level, taking with it the innocent investors who purchased while the manipulation was in progress.

OTC market manipulations are within the purview of federal securities laws and regulations.<sup>32</sup> The general antifraud provisions of the Securities Act of 1933<sup>33</sup> and the Securities Exchange Act of 1934<sup>34</sup> proscribe most of the devices used by manipulators to induce artificial price increases. Furthermore, the prohibition of certain specific manipulative practices on exchange markets applies as well to OTC transactions.<sup>35</sup> Pursuant to this statutory authority, the Securities Exchange Commission has promulgated rules and regulations addressed both to general fraudulent activity and to specific manipulative devices and practices. The broad scope of federal regulatory power seemingly would discourage most abuses in OTC markets.

Federal regulation is markedly deficient, however, in assuring that OTC markets are free from manipulative influence and in protecting the victims of price manipulations. While the SEC has generally been able to impose disciplinary or injunctive sanctions upon manipulators once a violation has been discovered, its ability to prevent manipulations from occurring in the first place is more limited. Broker-

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31. Manipulating dealers may also stimulate actual demand for a security as part of the manipulative process through the use of aggressive sales practices or misrepresentations to public customers. See, e.g., J.H. Goddard & Co., 42 S.E.C. 638 (1965); Advanced Research Associates, Inc., 41 S.E.C. 579 (1963); Bruns, Nordeman & Co., 40 S.E.C. 652 (1961); Gob Shops of America, Inc., 39 S.E.C. 92 (1959). Such tactics are especially effective when securities are sold to public customers who hold for investment rather than resale. See, e.g., SEC v. Rega, [Current] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975); SEC v. Resch-Cassin & Co., 362 F. Supp. 964 (S.D.N.Y. 1973).

32. For discussions of the application of federal securities laws and regulations to OTC market manipulation, see 2 A. BROMBERG, SECURITIES LAW: FRAUD § 8.4, at 204.41-204.65, 204.81-204.94 (1975); 3 L. LOSS, SECURITIES REGULATION 1563-70 (2d ed. 1961) [hereinafter cited as Loss]; Frey, *Federal Regulation of the Over-the-Counter Securities Market*, 106 U. PA. L. Rev. 1 (1957); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869, 915-26 (1972). See also *Market Makers, Manipulators and Shell Games*, *supra* note 19, at 597; Jacobs, *Regulation of Manipulation by SEC Rule 10b-5*, 18 N.Y.L. FORUM 513 (1973).

33. 15 U.S.C. §§ 77a-aa (1970).

34. 15 U.S.C. §§ 78a-hh (1970).

35. See text accompanying note 58 *infra*.

dealers participating in manipulations are, of course, the least likely to comply with SEC disclosure requirements that would facilitate early detection of the scheme. They may also be able to avoid per se application of certain anti-manipulative rules, thereby placing the burden of proving manipulative intent on the SEC enforcement authorities. Because evidence of manipulative intent is particularly difficult to compile before the manipulation has in fact commenced, the availability of preventive injunctions is somewhat remote. In addition, victims of manipulations are rarely able to recover their losses after the manipulation is completed and the offending dealer has finished his distribution or disposed of his accumulated inventory. Remarkably, the protective purposes of the federal securities laws continue to go unfulfilled in OTC markets.

The Securities Reform Act alters significantly the statutory and regulatory framework governing the exchange and OTC markets. One fundamental change is the redefinition of the SEC's role in overseeing operations on the securities markets. Consistent with the congressional view that free interaction of supply and demand in a competitive market may serve the protective purposes of the Exchange Act more efficiently than direct regulation,<sup>36</sup> the new statute directs the SEC to review existing and proposed rules of the self-regulatory organizations and to revise or abrogate any rules that unduly burden free competition.<sup>37</sup> While this mandate may appear to restrict the SEC's regulatory authority, the Reform Act actually contemplates only a shift in the focus of federal regulation: the SEC will now be primarily concerned with ensuring open and competitive market-places, unfettered by anti-competitive regulations. The Act specifically directs the SEC to promulgate standards of conduct for OTC market makers only in situations where natural competitive forces cannot be relied upon to ensure free and open markets.<sup>38</sup> This directive is consistent with the new regulatory philosophy of maintaining a "hands off" attitude unless certain specific situations require regulation in order to prevent distortion of natural competitive forces. Since manipulative devices interfere directly with the normal interaction of supply and demand, and hence with the free competition

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36. See SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, REPORT ON SECURITIES ACTS AMENDMENTS OF 1975, S. REP. NO. 94-75, 94th Cong., 1st Sess. 14 (1975), reprinted in U.S. CODE CONG. & AD. NEWS 613-777 (June 25, 1975) [hereinafter cited as SENATE REPORT ON SECURITIES ACTS AMENDMENTS OF 1975].

37. Securities Acts Amendments of 1975 §§ 4, 16, codified at 15 U.S.C.A. §§ 78f(b)(8), 78(b)-(c) (Supp. IV, 1975), amending Securities Exchange Act of 1934 §§ 6, 19, 15 U.S.C. §§ 78f, 78s (1970). For the legislative history behind these provisions, see SENATE REPORT ON SECURITIES ACTS AMENDMENTS OF 1975, *supra* note 36, at 12-14.

38. Securities Acts Amendments of 1975 § 11, codified at 15 U.S.C.A. § 78o(c)(5) (Supp. IV, 1975), amending Securities Exchange Act of 1934 § 15(c)(5), 15 U.S.C. § 78o(c)(5) (1970). For the legislative history behind this provision, see SENATE REPORT ON SECURITIES ACTS AMENDMENTS OF 1975, *supra* note 36, at 12.

envisioned by the Reform Act, the SEC is now fully empowered to adopt new rules to prevent manipulative practices.

This Article examines the scope of the existing regulations applicable to OTC market manipulations to identify the areas in which the SEC should focus its rulemaking authority under the Reform Act. Unwarranted price-raising and excessive accumulation of inventory emerge from this examination as blatant manipulative practices demanding more effective regulation. Two rules are proposed which address the deficiencies of the present law with respect to these practices. Finally, the scope of the proposed rules and possible mechanisms for enforcing them are considered.

## I. LEGAL REGULATION OF OTC MARKET MANIPULATION

### A. *The Statutory Scheme*

Prior to enactment of the New Deal securities legislation in the 1930's, market manipulation had a pervasive influence in impeding the operation of freely competitive securities markets. "Pool" operations, for example, were notorious on the exchange markets.<sup>39</sup> Similar manipulative practices plagued the OTC markets, although these practices were less publicized than the abuses on the national exchanges.<sup>40</sup> Legal regulation of manipulative schemes, both at com-

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39. In the typical pool operation, the pool operators would accumulate substantial holdings in a security, generate activity and public interest in the security, and finally unload the holdings on the market. Pools were often executed through contractual arrangements among the operators, and the profits resulting from the manipulations were at times spectacular. For descriptions of pool operations, see G. LEFLER & L. FARWELL, THE STOCK MARKET 453-61 (3d ed. 1963); TWENTIETH CENTURY FUND, THE SECURITY MARKETS 456-99 (1935); Ferrara, *SEC Division of Trading and Markets: Detection, Investigation and Enforcement of Selected Practices that Impair Investor Confidence in the Capital Markets*, 16 How. L.J. 950, 951-2 (1971).

40. See TWENTIETH CENTURY FUND, THE SECURITY MARKETS 264, 269 (1935); 10 SEC ANN. REP. 45 (1944).

The litigation that followed in the wake of the failure of the Harriman National Bank in 1931 is illustrative of early manipulative schemes and devices experienced in the OTC market. Suits were filed by a number of private parties when it was discovered that the bank was manipulating the market in its own stock for the purpose of maintaining a grossly inflated price. During the manipulation, bank executives maintained a close liaison with an OTC firm that specialized in bank stocks. The bank was able to support the market in its stock at a desired level by offering to purchase through the firm stock that had been offered for sale by public customers. A sufficient amount of purchases was made by the bank to ensure price maintenance.

In Wilcox v. Harriman Securities Corp., 10 F. Supp. 532 (S.D.N.Y. 1933), the federal district court denied defendants' motion to dismiss plaintiffs' action for rescission, stating:

If persons boost the quoted price of a stock above its real value by fictitious sales in order to induce the public to take over their stock at the artificial levels, one who acquires stock for value from the manipulators may treat the transaction as one infected by fraud and may rescind. The fact that information as to the sales at artificial figures comes to the victims by reports or quotations published in the newspapers rather than by direct communica-

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tions from the manipulators does not break the chain of causation. That is the very medium of information contemplated and intended by the operators of the plan.

*Id.* at 535.

In another suit, *Singleton v. Harriman*, 152 Misc. 323, 272 N.Y.S. 905 (Sup. Ct. 1933), *aff'd*, 241 App. Div. 857, 271 N.Y.S. 996 (1934), plaintiff was successful in her action for damages against the bank. The court found that there was no bona fide market for the stock, but rather that the bank had purposely maintained artificial price levels. Because the plaintiff purchased shares of the stock in reliance on false and fraudulent representations concerning bid and asked prices, she was entitled to relief. *Wilcox* and *Singleton* indicated clearly that the courts regarded the proscriptions against market manipulation as applicable to OTC markets as well as to exchange markets. This judicial posture signalled the development of the free and open competitive market concept as a guiding principle for both the OTC and exchange markets.

Despite the successes enjoyed by plaintiffs in *Wilcox* and *Singleton*, subsequent litigants encountered significant difficulties that prevented recovery of damages. In *Jaskow v. Harriman National Bank & Trust Co.*, 159 Misc. 39, 287 N.Y.S. 143 (Sup. Ct. 1935), the court dismissed a complaint for damages against the bank, despite the court's findings that the stock had been purchased by the plaintiff in reliance on fraudulent misrepresentations made by bank officers and that the market for the stock was being maintained artificially by the officers at the time of the stock purchases. The court based its decision on the grounds that the bank officers were acting *ultra vires* and that the bank had received no benefits from the officers' activities:

It has been repeatedly held that a national bank, contracting beyond its powers, is not liable for anything beyond what is received. . . . Assuming, therefore, that the bank, acting through its officers, did itself purport to sell the stock (instead of being a conduit through which the [Harriman Securities Corporation] sold it, as I find on this record), the public policy of the National Banking Act, aimed to protect depositors, would forbid recovery by a defrauded purchaser of the stock as against the bank, unless the bank, with the knowledge of the fraud, retained the proceeds of the sale.

*Id.* at 41, 287 N.Y.S. at 146.

The *Jaskow* court distinguished *Singleton* on the ground that in that case the bank had received the proceeds of the sale. Significantly, although the *Jaskow* court found that the bank officers had acted *ultra vires* in manipulating the price of the Harriman stock, the court stated that the plaintiff did have a cause of action against the individual officers who perpetrated the fraud.

Finally, in *Goess v. Lucinda Shops, Inc.*, 93 F.2d 449 (2d Cir. 1937), the court found, in contrast to the earlier Harriman Bank cases, that the bank had not "rigged" the market for its stock. A principal reason behind this finding was that, although it was customary for brokers who had stock for sale to call the bank for the purpose of obtaining a firm bid, such bids were not always secured. There were also occasions when the bank had purchased only part of the stock offered through the brokerage firm involved in the alleged price maintenance scheme. The third reason for the court's finding that no intentional manipulation had occurred was the lack of evidence of any agreements between the brokers and the bank to carry out the plan. Judge Manton wrote a vigorous dissenting opinion, recording his view that there was sufficient evidence of manipulation to let the case go to the jury. The dissenting opinion focused on the relation of the book value of the stock to its market value and how it was entirely reasonable that the jury could have found that the bank's selective purchases were made for the purpose, and actually did have the effect, of maintaining an inflated value. In accordance with fundamental common law principles, Judge Manton urged, interference with a free market was actionable:

In the instant case there was no showing of "wash" sales, but . . . the evidence does indicate manipulation by means of actual purchases by the bank of its own shares. But the principle is the same in both cases, since in each there is a representation that the quoted prices were arrived at in a

mon law and under state and federal statutes, was at best uneven and at worst ineffective.<sup>41</sup> Whether market manipulation flourished as a result of shortcomings in legal theory<sup>42</sup> or because of the lack of adequate enforcement,<sup>43</sup> it was clear by the late 1920's that manipulative activities had reached alarming dimensions. As the susceptibility of securities markets to manipulation became increasingly apparent, the demand for both punitive and preventive regulation grew.<sup>44</sup> Such corrective measures were finally made imperative by the loss of pub-

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"free" market. In both instances this representation is false, since, instead of a market price made by the free play of economic considerations, there is an artificial price foisted upon the public by duplicity.

*Id.* at 454.

41. For discussions of the legal regulation of securities markets prior to 1933, see 3 Loss, *supra* note 32, at 1531-40; Berle, *Stock Market Manipulation*, 38 COLUM. L. REV. 393 (1938); Berle, *Liability for Stock Market Manipulation*, 31 COLUM. L. REV. 264 (1931); Moore & Wiseman, *Market Manipulation and the Exchange Act*, 2 U. CHI. L. REV. 46 (1934); Comment, *Stock Market Manipulation at Common Law and Under Recent Federal Securities Legislation*, 28 CAL. L. REV. 378 (1940); Comment, *Manipulation of the Stock Markets Under the Securities Laws*, 99 U. PA. L. REV. 651 (1951); Comment, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 509 (1947). Case law reveals the problems encountered in regulating market manipulation prior to the enactment of securities legislation in the 1930's. See, e.g., *United States v. Brown*, 5 F. Supp. 81 (S.D.N.Y. 1933), *aff'd* 79 F.2d 321 (2d Cir. 1935), *cert. denied sub nom. McCarthy v. United States*, 296 U.S. 650 (1935).

Attempts to prevent the manipulation of public markets have a long history. English authorities made repeated efforts dating at least from the twelfth century to regulate practices designed to influence artificially the prices of commodities traded on public markets. Jones, *Historical Development of the Law of Business Competition*, 35 YALE L.J. 905, 906-07 (1926). Historical studies have revealed that market manipulation is not unique to modern times, but rather that:

[I]aws were found necessary to prohibit the spreading of false reports as to the state of the market (regrating), to prohibit the purchase of victuals on the way to market for purposes of resale (forestalling), and to prohibit the cornering of the available supply of an article (engrossing).

Mason, *Monopoly in Law and Economics*, 47 YALE L.J. 34, 38 (1937). For further discussion of market manipulation in England, see 4 W. BLACKSTONE, *COMMENTARIES* \* \*157-58.

42. The legal approach to the problem of market manipulation was primarily through the concept of fraud . . . . The reach of strict fraud doctrine was, however, far too short. . . . The fraud concept largely failed to reach manipulation by actual purchases and sales.

Comment, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 508, 516-17 (1947). For a discussion of the various approaches to regulation of manipulation, see 3 Loss, *supra* note 32, at 1430-36.

43. Professor Berle has asserted that the most significant impact of the securities legislation of the 1930's was the creation of the SEC, with its extensive investigatory powers and staff expertise, as a plaintiff in securities manipulation cases. Berle, *Stock Market Manipulation*, 38 COLUM. L. REV. 393, 398 (1938).

44. For a discussion of the events leading to the formulation of the anti-manipulative provisions of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1970), see Tracy & MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025 (1934). See also G. LEFFLER & L. FARWELL, *THE STOCK MARKET* 445-61 (3d ed. 1963); TWENTIETH CENTURY FUND, *THE SECURITY MARKETS* 443-508 (1935).

lic confidence in the securities markets in the aftermath of the market collapse of 1929 and by the widespread belief that manipulators had caused or at least exacerbated the breakdown.<sup>45</sup>

In response to the abuses revealed by congressional investigation of the 1929 collapse, Congress enacted the Securities Exchange Act of 1934.<sup>46</sup> A principal reason for passage of the Act was the adverse economic impact that manipulation and controlled markets had on the goal of maintaining open securities markets that were subject only to the forces of supply and demand.<sup>47</sup> Section 9 of the Act was designed to curb specific manipulative practices engaged in on exchange markets.<sup>48</sup> No comparable provision was enacted, however, to police similar unlawful practices occurring on OTC markets.<sup>49</sup> Conse-

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45. It is of more than passing interest that the blaze of popular wrath against the Exchange flamed up not when people found themselves stripped of their life's savings in the disorderly declines of 1929 and 1930, but later in 1931 when the notion got about that the decline was the work of a group of wicked bear raiders—professional speculators—who by selling short were driving prices lower and preventing recovery. People became convinced that the market continued to sag under pressure applied by the professional marauders of the Street. They clamored for action to check the infamy.

J. FLYNN, SECURITY SPECULATION: ITS ECONOMIC EFFECTS 216 (1934).

Dean Manning has expressed a similar view:

It is true that the legislative history of the acts contains statements to the effect that a major concern of the draftsmen was the protection of market behavior and control of those who put money into market speculation rather than into "investment." But, in my view, such economic statements were, at most, collateral to the main thrust of the legislative initiative taken in 1933 and 1934. Congress was confronted or felt it was confronted (and notice the rapidity with which it moved, with the securities acts almost the first order of business of the New Deal) with a major crisis occurring right at the heart of the flow-of-capital process—the loss of public confidence in the market. Something had to be done to reestablish that confidence. I would suggest that the economic recitations contained in the legislative history of the securities acts were no more the source of the political surge behind the legislation than, let us say, the Supreme Court's decision calling for integrating schools for Negroes and whites was really predicated upon sociological findings that segregated schooling does not provide as good an education as integrated schooling. In both cases the social science material, and the behaviorist assertions, are relevant—but are mainly a part of a supporting brief for action to meet an ethical-political problem.

Manning, *Discussion and Comments on Papers by Professor Demsetz & Professor Benston in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 81, 86-87 (H. Manne ed. 1969). See also R. DeBEDTS, *THE NEW DEAL'S SEC: THE FORMATIVE YEARS 1-85* (1964); M. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 103-44 (1970).

46. 15 U.S.C. §§ 78a-78hh (1970).

47. Securities Exchange Act of 1934, § 2(3), 15 U.S.C. § 78b(3)(1970).

48. Securities Exchange Act of 1934, § 9, 15 U.S.C. § 78i (1970).

49. A principal reason for the failure to enact OTC anti-manipulative provisions comparable to section 9 of the Securities Exchange Act was the dearth of information about OTC markets in 1934.

In contrast to other areas in which the Commission commenced its administrative duties in June 1934, there were little or no reliable data concerning

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the scope or nature of the abuses to which the directives of Section 15 of the Securities Exchange Act of 1934 were intended to apply. The long legislative history of the Securities Act of 1933 provided a rich source of information concerning the practices of underwriters and the evils encountered in connection with public offerings of new securities. The hearings before Committees of Congress and the Committee reports on bills to regulate securities markets, resulting in the enactment of the Securities Exchange Act, contained a wealth of basic data concerning the practices and abuses which had permeated the exchange markets during the preceding decade. But, as to over-the-counter markets, the legislative history of the Securities Exchange Act yields little information and sheds little light on the directives of Section 15 relating to over-the-counter regulation, beyond the obvious facts that unique opportunities for abuse existed in that market and that regulation of exchange markets made necessary the regulation of counter markets, since business tends to flow from regulated to unregulated areas.

10 SEC ANN. REP. 44 (1944). Obtaining reliable data about OTC markets proved to be one of the most difficult problems encountered by the SEC in conducting its **SPECIAL STUDY OF THE SECURITIES MARKETS**.

. . . [R]egulation of the over-the-counter markets continues to be considerably less pervasive and less exacting than in the case of the major exchanges.

The comparative lag in regulation may have been due partly to lack of information. Whereas there is a continuous flow of information about market and trading activities in the exchange markets, comparable information concerning the over-the-counter markets is not available. At any given time, unless a special investigation is undertaken, neither the number of broker-dealers participating in the over-the-counter markets, the number and type of issues traded in these markets, the aggregate volume of trading in such issues, nor the size, price or timing of individual transactions is known.

There is also a lack of information about the issuers of securities traded in the over-the-counter markets. Since most over-the-counter issuers are not subject to the reporting provisions of the Exchange Act, the Commission and the NASD, as well as the investing public, often have no source of continuing information concerning their operation.

At the time of the hearings on the legislation authorizing the Commission to make the Special Study, the absence of data concerning the over-the-counter markets was described by the Chairman of the Commission as a "fundamental problem," and one of the primary tasks of the study was stated to be the gathering of "important information concerning the actual operation of the over-the-counter market and the adequacy of the rules governing trading in that market."

**SPECIAL STUDY**, *supra* note 5, pt. 2, at 541-42. See also Lesh, *Federal Regulation of Over-the-Counter Brokers and Dealers in Securities*, 59 HARV. L. REV. 1237, 1242-43 (1946). Difficulty in obtaining data concerning OTC markets has resulted in large part from the extreme diffuseness and heterogeneity of such markets. See **SPECIAL STUDY**, *supra* note 5, pt. 2, at 546-53. I. FRIEND, G. HOFFMAN & W. WINN, *THE OVER-THE-COUNTER SECURITIES MARKETS* 41-42 (1958).

Since the enactment of the Securities Exchange Act of 1934, more information concerning the OTC markets has become available due largely to SEC and NASD studies and reporting requirements. For a listing of reports that OTC broker-dealers must file with the SEC and NASD, see *Report Coordinating Group, First Annual Report to the Securities and Exchange Commission*, exhibit 4 at 3 (June 16, 1975). Comprehensive SEC and NASD reporting requirements, however, apply only to exchange- and NASDAQ-listed securities and to OTC margin securities. Information about other stocks traded OTC is still not readily available. With the emergence and increasing utilization of sophisticated communications and data processing systems in the securities industry, market information about securities traded on both the exchange and OTC markets promises to be more complete and accessible. See Bleakley,

quently, attempts to regulate manipulative activities in OTC market operations were based initially on three general antifraud provisions: sections 10(b)<sup>50</sup> and 15(c)(1)<sup>51</sup> of the Securities Exchange Act of 1934, and section 17(a)<sup>52</sup> of the Securities Act of 1933.

Section 10(b) of the Exchange Act has a broad reach. It makes unlawful the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security.<sup>53</sup> Under section 15(c)(1), which is directed specifically at brokers and dealers operating in OTC markets, it is unlawful "to effect any transaction in, or to induce the purchase or sale of, any security . . . otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance."<sup>54</sup> Section 17(a) of the Securities Act of 1933 proscribes the use of fraudulent practices in connection with the sale of securities.<sup>55</sup>

Although there are certain important differences among these antifraud provisions, neither the SEC nor the federal courts has shown concern for the technical intricacies or distinctions in applying the statutes to OTC manipulation cases. This practice has evolved because of the generality and substantial overlap of the provisions and because the SEC is the predominant complainant in OTC manipulation cases. Virtually all proceedings and cases in this area have been SEC-initiated disciplinary actions or requests for injunctions rather

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*Is NASDAQ Really the Answer?*, 4 SECURITIES L. REV. 592 (1972); Comment, *The Development of the Central Market System: Revolution—One Step at a Time*, 3 RUTGERS J. OF COMPUTERS AND THE LAW 232 (1973). For example, OTC transactions in listed securities are now reported on the consolidated tape. See SEC rule 17a-15, 17 C.F.R. § 240.17a-15 (1975).

The "potential scope and complexity of over-the-counter regulation" also contributed to the failure to enact OTC anti-manipulative provisions comparable to section 9 of the Exchange Act. SPECIAL STUDY, *supra* note 5, pt. 4, at 604. In place of rigid statutory provisions that could not anticipate the myriad of problems that could arise on the OTC markets, the Exchange Act "entrusted to the Commission broad rulemaking powers over the over-the-counter markets rather than creating a detailed system of regulation as in the case of the exchanges." *Id.*

50. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970).

51. Securities Exchange Act of 1934, § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1970).

52. Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a)(1970).

53. The literature dealing with section 10(b), and particularly rule 10b-5, is voluminous. For especially helpful discussions of the application of section 10(b) and rule 10b-5 to broker-dealer regulation, see 1 A. BROMBERG, SECURITIES LAW: FRAUD §§ 5.1-5.6 at 90-104 (1975); E. WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS 195-98 (1965); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869 (1972); Jacobs, *Regulation of Manipulation by SEC Rule 10b-5*, 18 N.Y.L. FORUM 513 (1973).

54. Section 15(c)(1) was added to the Securities Exchange Act by amendment in 1936. The purpose of the amendment was to grant authority to the SEC to define manipulative, deceptive, and other fraudulent devices and contrivances. In 1938, section 15(c)(1) was amended to empower the SEC to prohibit the practices it had identified as illegal. See 10 SEC ANN. REP. 47 (1944).

55. See generally 1 A. BROMBERG, SECURITIES LAW: FRAUD § 2.1 at 17-20 (1975); 3 Loss, *supra* note 32, at 1423-24, 1442-44.

than private actions for damages.<sup>56</sup> The usual approach taken by the SEC is to allege that certain facts evidencing manipulative activity violate section 17(a) of the Securities Act of 1933, sections 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, and rules 10b-5 and 15c1-2 promulgated pursuant to the Exchange Act. Undifferentiated application of these antifraud provisions produces a "composite effect"<sup>57</sup> in making OTC manipulative activities unlawful.

In addition to these general antifraud provisions regulating OTC market manipulation, the specific prohibitions of section 9(a) of the Exchange Act have been applied to OTC transactions through section 15(c)(1) of the Act.<sup>58</sup> In the first formal proceeding involving OTC market manipulation, the SEC stated:

We think that there is no reasonable distinction . . . between manipulation of over-the-counter prices and manipulation of prices on a national securities exchange, and that both are condemned as fraudulent by the Securities Exchange Act and, in fact, were fraudulent at common law . . . We believe that the Securities Exchange Act contemplates that Section 15(c)(1) affords to the over-the-counter market at least as great a degree of protection against manipulation or attempted control as is afforded to the exchange market by Section 9(a).<sup>59</sup>

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56. There are a number of reasons why OTC manipulation cases are predominantly SEC enforcement actions. The principal reason is the difficulty of proving a violation of pertinent statutory provisions or rules. A private litigant has few, if any, of the investigative resources available to the SEC. Moreover, by the time it becomes evident that a manipulation has occurred, there is often no person with sufficient funds available to satisfy any judgment secured by the private litigant.

In addition to civil suits brought by the SEC, market manipulators may also be prosecuted criminally under section 32(a) of the Securities Exchange Act, 15 U.S.C. § 78ff (1970). *E.g.*, United States v. Cohen, [Current] CCH FED. SEC. L. REP. ¶ 95,217 (S.D.N.Y. 1975).

57. The composite effect of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule X-10B-5 is to make unlawful the use of the mails or any means or instrumentality of interstate commerce by any person in order to effect a purchase or sale of a security where a device to defraud is employed, where an untrue statement or a misleading omission with respect to a material fact is made, or where such person engages in any act, practice, or course of business which operates or would operate as a fraud or deceit upon a customer. Section 15(c)(1) of the Exchange Act and Rule X-15C1-2 thereunder, which apply only to brokers and dealers and to transactions effected otherwise than on a national securities exchange, contain similar provisions.

R.L. Emacio & Co., 35 S.E.C. 191, 202 n.29 (1953). See Edgerton, Wykoff & Co., 36 S.E.C. 583 (1955); Floyd A. Allen & Co., 35 S.E.C. 176 (1953).

58. See, e.g., SEC v. Rega, [Current] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975); SEC v. D'Onofrio, [Current] CCH FED. SEC. L. REP. ¶ 95,201 (S.D.N.Y. 1975); SEC v. Resch-Cassin & Co., 362 F. Supp. 964 (S.D.N.Y. 1973); American Bank & Trust Co. v. Barad Shaff Securities Corp., 335 F. Supp. 1276 (S.D.N.Y. 1972); Halsey, Stuart & Co., 30 S.E.C. 106 (1949); Barrett & Co., 9 S.E.C. 319 (1941).

59. Barrett & Co., 9 S.E.C. 319, 328 (1941).

It has also been held that the manipulative activities prohibited by section 9(a)(2) constitute violations of section 17(a) of the Securities Act of 1933 and section 10(b) of the Exchange Act when such activities occur in OTC transactions.<sup>60</sup>

It is the broad prohibition of subsection (2) of section 9(a) that the SEC considers to be "the very heart"<sup>61</sup> of the Exchange Act. This subsection makes it unlawful to

effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.<sup>62</sup>

The broad scope of this provision has led the SEC to employ it more frequently than the other narrower proscriptions of section 9(a) which make unlawful a number of specific manipulative practices.<sup>63</sup> The breadth of the prohibition, however, fails to provide adequate guidance to broker-dealers operating in an environment where trading decisions often must be made quickly.<sup>64</sup> For the same reason, enforcement of section 9(a)(2) against manipulators is problematical. The principal impediment to proving a violation of section 9(a)(2) is establishing the element of intent. Broker-dealers are not culpable under the provision unless they engaged in a series of transactions for the purpose of inducing others to buy or sell a certain security.<sup>65</sup> The need to prove manipulative purpose has largely precluded private parties from bringing damage actions under the statute and has placed an onerous burden on the SEC in its attempts to use section 9(a)(2) to curb market manipulation.<sup>66</sup>

One final anti-manipulative provision the SEC has employed is section 15(c)(2) of the Exchange Act, which prohibits the making of

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60. SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 975 (S.D.N.Y. 1973).

61. See 3 Loss, *supra* note 32, at 1549.

62. Securities Exchange Act of 1934, § 9(a)(2), 15 U.S.C. § 78i(a)(2) (1970).

63. Section 9(a)(1), 15 U.S.C. § 78i(a)(1) (1970), prohibits wash sales and matched orders designed to create a false appearance of active trading. Transactions entered into for the purpose of "pegging, fixing or stabilizing the price" of securities in contravention of SEC rules and regulations are proscribed by section 9(a)(6), 15 U.S.C. § 78i(a)(b) (1970). See generally 2 A. BROMBERG, *SECURITIES LAW. FRAUD*, § 8.4 at 204.41-204.65 (1975); 3 Loss, *supra* note 32, at 1541-68; Mathias, *Manipulative Practices and the Securities Exchange Act*, 3 U. PITTS. L. REV. 7 (1936); Note, *Manipulation of the Stock Markets Under the Securities Laws*, 99 U. PA. L. REV. 651, 657-69 (1951); Comment, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 509, 524-30 (1947). Specific manipulative practices in connection with short sales are prohibited by section 10(a) of the Exchange Act, 15 U.S.C. § 78j(a)(1970).

64. Cf. Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 846 (1973).

65. See 3 Loss, *supra* note 32, at 1550-57.

66. The burden of proof on the issue of manipulative intent or purpose is on the plaintiff, whether the plaintiff is the SEC, the Government, or a private party. *Id.* at 1557.

"any fictitious quotation."<sup>67</sup> This section also directs the SEC to prescribe rules and regulations to define and prevent manipulation through such quotations.

### B. SEC and NASD Rules and Regulations

The existing anti-manipulative statutory provisions are complemented by an extensive set of rules and regulations. Recognizing that the statutory framework could not cover all possible manipulative schemes, Congress empowered the SEC to promulgate rules and regulations needed to deal with particular problems.<sup>68</sup> In addition, the National Association of Securities Dealers, Inc. (NASD) has promulgated rules governing the activities of member brokers and dealers.<sup>69</sup> Broker-dealers who violate an SEC rule or regulation are subject to disciplinary proceedings or injunctions imposed by the Commission to prevent further offensive conduct.<sup>70</sup> The NASD Board of Governors also enforces its rules through disciplinary actions.<sup>71</sup> Moreover, SEC and NASD enforcement efforts are supplemented by private causes

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67. 15 U.S.C. § 78o(c)(2) (1970).

68. E.g., Securities Exchange Act of 1934, §§ 15(c)(1), 15(c)(2), 15(c)(5), 15 U.S.C. §§ 78o(c)(1), 78o(c)(2), 78o(c)(5) (1970).

69. The National Association of Securities Dealers, Inc. is a self-regulatory organization of OTC brokers and dealers registered pursuant to section 15A of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78o-3(a), 78o-3(b) (1970). For a description of the characteristics and functions of the NASD, see Application of the Nat'l Ass'n of Securities Dealers, Inc., 5 S.E.C. 627 (1939). See 2 Loss, *supra* note 32, at 1365-69; Resch, *National Association of Securities Dealers, Inc.* in THE STOCK MARKET HANDBOOK 176 (F. Zarb & G. Kerekes eds. 1970); Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW AND CONTEMP. PROB. 663 (1964).

Approximately 85% of all registered broker-dealers are members of the NASD. 40 SEC ANN. REP. 52, 56 (1974). As a practical matter, a broker-dealer who engages in almost any aspect of the OTC securities business must be a member of the NASD because of the NASD rule providing that no "member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public." *NASD Rules of Fair Practice*, art. III, § 25(a), CCH NASD MANUAL ¶ 2175 (1971). This rule is authorized by Securities Exchange Act of 1934, § 15A(i)(1), 15 U.S.C. § 78o-3 (i)(1), which provides:

The rules of a registered securities association may provide that no member thereof shall deal with any nonmember broker or dealer . . . except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

The purpose of this provision is to provide an economic incentive for OTC brokers and dealers to join a self-regulatory national securities association. Nat'l Ass'n of Securities Dealers, Inc., 44 S.E.C. 896, 898-99 (1972); SPECIAL STUDY, *supra* note 5, pt. 4, at 605. The NASD is the only such association at present. Membership in the NASD is open to all registered brokers and dealers. Nat'l Ass'n of Securities Dealers, Inc., 12 S.E.C. 322 (1942).

70. See 2 Loss, *supra* note 32, at 1301-12; 3 Loss, at 1568-70.

71. See 2 Loss, *supra* note 32, at 1371-80.

of action under some of the SEC and NASD rules.<sup>72</sup>

The SEC's regulatory scheme is designed to protect investors from manipulative and fraudulent schemes and to maintain competitive securities markets, responsive solely to the forces of supply and demand. The rules that have figured most prominently in the SEC's efforts to achieve these goals have been promulgated under sections 10(b),<sup>73</sup> 15(c)(1),<sup>74</sup> and 15(c)(2)<sup>75</sup> of the Securities Exchange Act of 1934. These rules set forth both general and specific prohibitions formulated to combat a broad range of fraudulent and manipulative practices. The most far-reaching of these prohibitions are contained in rule 10b-5, which makes it unlawful for any person

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>76</sup>

Because the proscriptions in rule 10b-5 are sufficiently general to encompass most forms of market manipulation, SEC proceedings against manipulators are almost invariably predicated, at least in part, on the rule. Its outer limits are constantly expanding; the voluminous body of decisional law interpreting rule 10b-5 reveals that conduct in the trade which at one time may have been widespread and generally regarded as permissible may turn out in subsequent litigation or proceedings before the SEC to be unlawful.<sup>77</sup> As a result,

72. Compare *Franklin Nat'l Bank v. L.B. Meadows & Co.*, 318 F. Supp. 1339 (E.D.N.Y. 1970) (implied liability to private parties for violation of Securities Exchange Act of 1934, § 15(c)(2), 15 U.S.C. § 78o(c)(2) (1970) and SEC rule 15c2-7, 17 C.F.R. § 240.15c2-7 (1970)), with *Cutner v. Fried*, 373 F. Supp. 4 (S.D.N.Y. 1974) (private cause of action under Securities Exchange Act of 1934, § 11(b), 15 U.S.C. § 78k(b) (1970) and SEC rule 11b-1, 17 C.F.R. § 240.11b-1 (1970) denied). See *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Schaefer v. First Nat'l Bank*, 509 F.2d 1287 (7th Cir. 1975); *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); *Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12 (1966); *Lowenfels, Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L.Q. 633 (1966); *Wolfson & Russo, The Stock Exchange Member: Liability For Violation of Stock Exchange Rules*, 58 CALIF. L. REV. 1120 (1970); Comment, *Liability Implications of Stock Exchange Margin Maintenance Rules*, 26 MAINE L. REV. 378 (1974).

73. 15 U.S.C. § 78j(b) (1970).

74. *Id.* § 78o(c)(1).

75. *Id.* § 78o(c)(2).

76. 17 C.F.R. § 240.10b-5 (1975).

77. The elastic scope of rule 10b-5 is illustrated by *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1971) in which the court held that a broker-dealer had violated rule 10b-5 by failing to disclose that it was acting as a market maker for several OTC securities that it had sold to a public customer. The notable aspect of the case is that

there are areas of broker-dealer conduct in which there are no definite guidelines for compliance with the 10b-5 prohibitions. From the point of view of the SEC, this may be desirable, as the flexibility of the rule may encourage some form of self-policing by broker-dealers. But from the vantage point of the broker-dealer, the resulting uncertainty injects an additional element of complexity into the already demanding and fast-moving process of conducting trading activities on OTC markets.

The SEC rules promulgated under sections 15(c)(1) and 15(c)(2) of the Exchange Act are more specific than those promulgated under section 10(b).<sup>78</sup> For example, rule 15c1-4<sup>79</sup> requires broker-dealers to state the capacity in which they are acting when confirming transac-

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the broker-dealer was held liable even though "in 1961 no rule of the SEC (other than, allegedly, the inevitable Rule 10b-5), the NASD or the New York Stock Exchange required disclosure of that fact to a customer." *Id.* at 1174 (Friendly, J., dissenting from the denial of reconsideration *en banc*). See Comment, *Non-Disclosure of Market-Maker Status by Broker-Dealer Held a Violation of Rule 10b-5*, 71 COLUM. L. REV. 495 (1971).

78. One important exception is rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1975), which contains an extremely broad anti-manipulative prohibition phrased in general terms, similar in scope and language to rule 10b-5. Rule 15c1-2 provides:

- (a) The term "manipulative, deceptive, or other fraudulent device or contrivance", as used in section 15(c)(1) of the act (sec. 2, 52 Stat. 1075; 15 U.S.C. 78o(c)(1)), is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.
- (b) The term "manipulative, deceptive, or other fraudulent device or contrivance", as used in section 15(c)(1) of the act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.
- (c) The scope of this section shall not be limited by any specific definitions of the term "manipulative, deceptive, or other fraudulent device or contrivance" contained in other rules adopted pursuant to section 15(c)(1) of the act.

79. 17 C.F.R. § 240.15c1-4 (1975). Rule 15c1-4 is designed to inform the customer whether the broker-dealer is acting as principal or agent in a given transaction. If the broker-dealer is acting as agent, he is compensated by a commission. If he is acting as principal, he makes his profit on retail mark-up. Upon receiving an order, a broker-dealer usually is free to choose how he will handle a transaction, as principal purchasing the security for himself and then reselling to the customer at a marked-up price, or as agent for the customer. When acting as an agent, rule 15c1-4(a)(2) requires the broker-dealer to disclose the amount of his commission. There is no comparable requirement in principal transactions obligating the broker-dealer to disclose the amount of the mark-up. Note, however, that it has been held that where a special relationship of trust and confidence exists between broker and client, the broker may have to provide the client with information about any change in the broker's status to a greater extent than rule 15c1-4 expressly requires. *Cant v. A.G. Becker & Co.*, 374 F. Supp. 36 (N.D. Ill. 1974). Cf. *NASD Rules of Fair Practice*, art. III, § 4, CCH NASD MANUAL ¶ 2154 (1971), which requires retail prices in principal transactions to be "fair, taking into consideration all relevant circumstances."

tions with clients. Rule 15c1-6<sup>80</sup> compels broker-dealers to disclose their financial interests in any primary or secondary distributions in which they are participating. Other activities prohibited by this set of rules include: (1) an excessive number of transactions designed to "churn" discretionary accounts;<sup>81</sup> (2) representations by a broker-dealer participating in a distribution that a security is being offered "at the market" when there are no grounds for asserting that an independent public market for the security actually exists;<sup>82</sup> and (3) the initiation or resumption of quotations for a security by a broker-dealer who lacks certain specified information about the issuer.<sup>83</sup>

Many of the manipulative practices that are prohibited by the SEC rules are also outlawed by virtually identical NASD rules. Section 18 of the *NASD Rules of Fair Practice*, for example, states that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive, or other fraudulent device or contrivance."<sup>84</sup> Patterned after SEC rule 10b-5, this general antifraud provision has been used by NASD authorities as a basis for bringing disciplinary actions against members for such activities as withholding "hot issues,"<sup>85</sup> "interpositioning,"<sup>86</sup> and

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80. 17 C.F.R. § 240.15c1-6 (1975). Cf. *NASD Rules of Fair Practice*, art. III, § 14, CCH NASD MANUAL ¶ 2164 (1971).

81. SEC rule 15c1-7, 17 C.F.R. § 240.15c1-7 (1975). Cf. *NASD Rules of Fair Practice*, art. III, § 15(a), CCH NASD Manual ¶ 2165 (1971). See generally Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967).

82. SEC rule 15c1-8, 17 C.F.R. § 240.15c1-8 (1975). Cf. *NASD Rules of Fair Practice*, art. III, § 16, CCH NASD MANUAL ¶ 2166 (1971).

83. SEC rule 15c2-11, 17 C.F.R. § 240.15c2-11 (1975). Rule 15c2-11 was designed to prevent trading from developing in securities about which there is no current public information available. To this end, the rule was meant "to insure that before a broker-dealer publishes a quotation respecting a security at a specified price he has certain minimum information concerning that security." Amswiss Internat'l Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,504 (1973). It has been suggested that "a possible effect of the Rule may be in the long run (since it has no retroactive effect) to eliminate all trading in non-registered securities in the over-the-counter market, and this may very well have been its intent." R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 866 (3d ed. 1972).

84. *NASD Rules of Fair Practice*, art. III, § 18, CCH NASD MANUAL ¶ 2168 (1971).

85. "Hot issues" are stocks possessing characteristics that make them attractive to speculators looking for rapid growth, such as stocks in the electronics field. See 3 Loss, *supra* note 32, at 1482 n.27. THE SPECIAL STUDY, *supra* note 5, pt. 2, at 528, revealed that it was common for underwriters of a new issue to withhold substantial amounts of the issue during distribution. This practice was found to be one of the most pervasive and troublesome factors in restricting the supply of stock of a new issue.

86. The practice of "interpositioning" occurs when a retail dealer places an order for a security with a wholesaler who does not make a market in that security and who therefore must obtain the security from a firm that does. For example, a West Coast firm may know that a firm in New York is making a market in a certain security, but the West Coast firm may not have direct wire communications with the New York firm. To save the expense of a long distance call, the West Coast firm may contact a nearby correspondent firm of the New York firm with the instruction to relay an order to New York. In this sequence of events, the correspondent firm is "interpositioned"

using false confirmations in "boiler-room" operations.<sup>87</sup> In addition to the overlapping SEC and NASD prohibitions, there are a number of NASD rules that have no specific counterpart in the SEC regulatory scheme. Section 1 of the *Rules of Fair Practice* provides a general ethical guideline for broker-dealers by admonishing members to "observe high standards of commercial honor and just and equitable principles of trade."<sup>88</sup> To further this ideal, other more particularized Fair Practice Rules prohibit certain specific activities, such as making fictitious quotations<sup>89</sup> and providing baseless recommendations for the purchase or sale of securities.<sup>90</sup> The NASD Board of Governors has given further substantive content to section 1 of the Rules through "interpretations" that define explicitly certain prohibited practices such as "interpositioning"<sup>91</sup> and "free-riding and withholding."<sup>92</sup>

Although a number of NASD rules and interpretations identify and prohibit certain manipulative activities not covered expressly by the SEC scheme, the NASD rules and interpretations function primarily to reinforce SEC regulation of market manipulation. As the governmental agency responsible for the regulation of securities markets, the SEC is empowered to disapprove any changes in or additions to NASD rules.<sup>93</sup> The SEC is also authorized to abrogate any rule of the

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and receives a commission for the service it has performed. This extra charge is passed on to the customer.

Another reason for interpositioning a broker-dealer unnecessarily in executing an order is to compensate the interpositioned dealer for reciprocal business. In *Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971), for example, an order clerk in a retail firm made numerous purchases and sales of OTC securities for the firm's customers through another firm rather than placing the orders directly with dealers quoting the securities involved. In return for the business, the interpositioned firm placed reciprocal orders with the order clerk, thus generating commission business for him. For discussions of interpositioning, see SPECIAL STUDY, *supra* note 5, pt. 2, at 620-23; *Market-Makers, Manipulators and Shell Games*, *supra* note 19, at 597, 602 n.9.

87. Especially aggressive efforts by a broker-dealer's retail sales force to dispose of a block of a particular stock may be characterized as a "boiler-room" operation. The characteristics of a boiler-room operation that may distinguish it from legitimate merchandising activity are the disposition of a highly speculative stock, the use of an unusually large number of telephones, and accumulation of shares in controlled or fictitious accounts prior to unloading them on the market. See Palombi Securities Co., SEC Exchange Act Release No. 6961 (Nov. 30, 1962). For a discussion of boiler-room operations and the SEC's approach to regulating them, see *Market-Makers, Manipulators and Shell Games*, *supra* note 19, at 607-09.

88. *NASD Rules of Fair Practice*, art. III, § 1, CCH NASD MANUAL ¶ 2151 (1971).

89. *Id.* § 5 at ¶ 2155.

90. *Id.* § 2 at ¶ 2152.

91. *Interpretation of the Board of Governors, Execution of Retail Transactions in the Over-the-Counter Market*, CCH NASD MANUAL ¶ 2151.03 (1971).

92. *Interpretation of the Board of Governors, "Free Riding and Withholding"*, CCH NASD MANUAL ¶ 2151.06 (1971).

93. Securities Exchange Act of 1934, § 15A(j), 15 U.S.C. § 78o-3(j) (1970). For a discussion of the scope of the SEC's authority in disapproving or abrogating NASD rules in comparison with the extent of the SEC's power to review analogous exchange

NASD if such action is necessary to ensure fair dealings by the Association members, to protect investors, and to effectuate the purposes of the Exchange Act.<sup>94</sup> In addition, the Commission is empowered to review final decisions of the NASD Board of Governors on disciplinary actions.<sup>95</sup> Thus, while the NASD is credited with having improved the ethical standards of the trade generally,<sup>96</sup> legal regulation of market manipulation depends primarily on the SEC.

The two SEC rules having the most significant impact on regulation of OTC market manipulation are rule 15c2-7<sup>97</sup> and rule 10b-6.<sup>98</sup> Rule 15c2-7 imposes certain disclosure obligations on broker-dealers who are furnishing quotations for securities to an interdealer quotation system. Rule 10b-6 governs market transactions by participants and prospective participants in securities distributions. Almost all OTC manipulative schemes involve practices that fall within the scope of one or both of these rules.

Ideally, regulation of market manipulation should foreclose manipulative conduct before innocent purchasers invest in a security rather than merely provide authority to impose sanctions after the manipulation is completed and "the plug has been pulled."<sup>99</sup> In the latter situation, the losses of investors are rarely recovered, and confidence in public securities markets diminishes. Examination of rules 15c2-7 and 10b-6 reveals, however, that there are fundamental difficulties in applying these rules.

### 1. Rule 15c2-7

Rule 15c2-7 requires broker-dealers who are submitting quotations to an interdealer quotation system to identify any quotation that is submitted on behalf of another broker-dealer or in furtherance of certain arrangements between the submitting broker-dealer and another broker-dealer or other broker-dealers.<sup>100</sup> The interdealer quotation system, in turn, discloses this information. The disclosure principle behind this rule is designed to combat the commonly used manipulative device of one broker-dealer inducing other broker-dealers to enter quotations in a security for the purpose of creating the misleading impression that there is an active, independent market for the security.<sup>101</sup> In attempting to inflate artificially a stock's price, the

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rules, see Pozen, *Competition and Regulation in the Stock Markets*, 73 Mich. L. Rev. 317, 320 nn.12-14 (1974).

94. Securities Exchange Act of 1934, § 15A(k)(1), 15 U.S.C. § 78o-3(k)(1) (1970).

95. Securities Exchange Act of 1934, § 15A(g), 15 U.S.C. § 78o-3(g) (1970).

96. See 2 Loss, *supra* note 32, at 1389-91.

97. 17 C.F.R. § 240.15c2-7 (1975).

98. 17 C.F.R. § 240.10b-6 (1975).

99. 3 Loss, *supra* note 32, at 1569.

100. 17 C.F.R. § 240.15c2-7 (1975).

101. This device is one of the most persistent and difficult to regulate of all manipulative schemes affecting the securities industry. There has been extensive litigation

principal manipulator will often induce other broker-dealers participating in the scheme to submit the exact quotations he wants entered.<sup>102</sup> This may be accomplished by assurances from the principal manipulator that he will purchase at a stipulated price any shares that the confederate broker-dealers obtain during the manipulation.<sup>103</sup>

There are numerous conceivable purposes behind the creation of an artificially high market price by one broker-dealer through other broker-dealers. For example, the device may be employed by a broker-dealer who is participating in a distribution and who wishes to hide the fact that he is entering quotations for or purchasing the stock he is in the process of distributing.<sup>104</sup> Furthermore, devices to inflate a security's quoted price are often used to assist a "best efforts" or "all or nothing" distribution.<sup>105</sup> A "bull" manipulation facilitates such distributions by making it appear that there is an active market for the security being distributed. The scheme has also been

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involving this type of scheme. *E.g.*, SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); SEC v. Rega, [Current] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975); SEC v. Resch-Cassin & Co., 362 F.Supp. 964 (S.D.N.Y. 1973); Cohen Goren Equities, Inc., SEC Exchange Act Release No. 10,252 [1973 Transfer Binder]; CCH FED. SEC. L. REP. ¶ 79,421 (June 28, 1973). See also Dlugash v. SEC, 373 F.2d 107 (2d Cir. 1967); Tager v. SEC, 344 F.2d 5 (2d Cir. 1965); SEC v. Scott Taylor & Co., 183 F. Supp. 904 (S.D.N.Y. 1959); Advanced Research Associates, Inc., 41 S.E.C. 579 (1963); Theodore A. Landau, 40 S.E.C. 1119 (1962); Lawrence Rappee, 40 S.E.C. 607 (1962); R.L. Emacio & Co., 35 S.E.C. 191 (1953); Adams & Co., 33 S.E.C. 444 (1952); M.S. Wein & Co., 23 S.E.C. 735 (1946); Masland, Fernon & Anderson, 9 S.E.C. 338 (1941); Barrett & Co., 9 S.E.C. 319 (1941); SPECIAL STUDY, *supra* note 5, pt. 2, at 605-09.

102. See, e.g., SEC v. Resch-Cassin & Co., 362 F. Supp. 964 (S.D.N.Y. 1973); SEC v. Scott Taylor & Co., 183 F. Supp. 904 (S.D.N.Y. 1959); Theodore A. Landau, 40 S.E.C. 1119 (1962).

103. See SEC v. Resch-Cassin & Co., 362 F. Supp. (S.D.N.Y. 1973); M.S. Wein & Co., 23 S.E.C. 735 (1946).

104. See, e.g., Theodore A. Landau, 40 S.E.C. 1119 (1962). In that case, Scott Taylor was a broker-dealer engaged in an unregistered distribution of securities. A confederate broker-dealer, Landau, agreed with Scott Taylor to bid for and purchase shares of the security during the distribution. This arrangement was held to be a violation of rule 10b-6:

At the same time, Landau, by agreement with Scott Taylor, continuously bid for and purchased shares of stock. We conclude, as did the hearing examiner, that this was a manipulative and deceptive device in violation of Rule 10b-6 and Section 10(b) of the Exchange Act. It is clear that Scott Taylor would have violated Rule 10b-6 if it had inserted bids for Anaconda Lead in the "pink sheets." Under the circumstances of this case, it was improper for Landau to submit bids for Scott Taylor and thereby accomplish indirectly what Scott Taylor could not do directly.

*Id.* at 1125.

105. E.g. SEC v. Cooper, 402 F. Supp. 516 (S.D.N.Y. 1975); SEC v. Rega, [Current] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975); SEC v. Resch-Cassin & Co., 362 F. Supp. 964 (S.D.N.Y. 1973); R.L. Emacio & Co., 35 S.E.C. 191 (1953). In *Emacio*, the Commission stated: "Raising or maintaining prices at an artificial level is as much a manipulation whether its purpose is to fix prices for shares already acquired or [to fix prices for shares] to be acquired." *Id.* at 199 n.24.

employed to create an artificially high market value to make the security more attractive as collateral for a bank loan or in connection with merger negotiations.<sup>106</sup>

When a violation of rule 15c2-7 is discovered, the SEC usually has encountered little difficulty in identifying the broker-dealers participating in the scheme and in imposing appropriate disciplinary or injunctive sanctions. An essential element in proving a violation of rule 15c2-7 is establishing that the broker-dealers furnishing the quotations were acting in concert. Direct testimony will often supply the necessary evidence. Even in the absence of such testimony, however, objective data showing the related activity and movement of stock quotations may supply persuasive evidence of intentional manipulation.<sup>107</sup>

Rule 15c2-7 suffers, however, from two inherent inadequacies. First, it is unlikely that broker-dealers engaged in manipulating the market will comply with the rule. The principal manipulator can inflate the price of a security simply by persuading other broker-dealers to submit quotations to the interdealer quotation system for him without indicating the arrangements behind the transactions. Similarly, broker-dealers participating in a distribution who bid for or purchase shares of the security being distributed may mask these activities through the same type of plan. Violations of rule 15c2-7 are difficult to detect in such cases unless other less well disguised transgressions result in an investigation. Adequate enforcement of the rule is therefore unlikely or, at best, random in those very situations where its protections are most needed. Consequently, general noncompliance and inadequate enforcement serve to nullify the disclosure principle upon which the rule is based.

The second inadequacy of rule 15c2-7 as an anti-manipulative provision is that imposition of its remedial sanctions occurs, if at all, too late to prevent the harm arising from a manipulation. Because enforcement authorities usually learn of violations only after the manipulation is completed, innocent purchasers must suffer the adverse financial consequences of having invested in an essentially worthless security. Although the offending broker-dealers may be disciplined for their transgressions,<sup>108</sup> the rule fails to effectuate its ultimate pur-

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106. See, e.g., *Franklin Nat'l Bank v. L.B. Meadows & Co.*, 318 F. Supp. 1339 (E.D.N.Y. 1970).

107. E.g., *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 970 n.7 (S.D.N.Y. 1973).

108. Broker-dealers who aid the principal manipulator by submitting quotations during the manipulation are also vulnerable to prosecution or imposition of disciplinary sanctions by the SEC. See *SEC v. Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *SEC v. Rega*, [Current] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975); *Theodore A. Landau*, 40 S.E.C. 1119 (1962).

In the *Rega* case, *supra*, the court articulated the test to be applied for determining liability of an accomplice broker-dealer involved in a manipulation:

In [SEC] v. Spectrum, Ltd., 489 F.2d 535, 541 (2d Cir. 1973) the Second

pose of protecting the investing public from fraud and manipulation. Thus, while rule 15c2-7 provides the basis for a cure once the problem has been diagnosed, it is not an adequate preventive measure.

## 2. Rule 10b-6

Rule 10b-6 is aimed at preventing manipulative activities in connection with the distribution of securities. The rule makes it unlawful for any person who is presently or prospectively involved in a distribution to

bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution. . . .<sup>109</sup>

The purpose of the prohibition is to ensure that there is a free, open, and competitive market for the security being distributed.<sup>110</sup> Failure to comply with the proscriptions of rule 10b-6, for whatever reason, is deemed to be manipulative *per se* and thus unlawful. Intent is not a factor in determining whether particular conduct violates the rule: any departure from its express provisions is actionable, even though the particular activity is devoid of manipulative purpose<sup>111</sup> and in fact had no effect on the market for the security being distributed.<sup>112</sup> This *per se* approach differs significantly from those SEC rules based on

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Circuit explicitly indicated that in measuring liability as an aider and abettor a negligence standard should be employed. The test, therefore, is whether the "defendant should have been able to conclude that his act was likely to be used in furtherance of illegal activity." SEC v. Management Dynamics, Inc., [515 F.2d 801, 811 (2d Cir. 1975).] Knowledge that a violation is being committed and intent to further the illegal act is not required. SEC v. Spectrum, *supra*. It is sufficient if the defendant had reason to know or should have known that an illegal scheme was afoot and that his conduct would contribute to its success.

109. SEC rule 10b-6(a), 17 C.F.R. § 240.10b-6(a) (1975).

110. See Chris-Craft Indus. v. Bangor Punta Corp., 246 F.2d 569, 577 (1970); Bruns, Nordeman & Co., 40 S.E.C. 652, 660 (1961). For general discussion of rule 10b-6, see 3 Loss, *supra* note 32, at 1595-1604; Foshay, *Market Activities of Participants in Securities Distributions*, 45 VA. L. REV. 907 (1959); Weiss & Leibowitz, *Rule 10b-6 Revisited*, 39 GEO. WASH. L. REV. 474 (1971); Whitney, *Rule 10b-6: The Special Study's Rediscovered Rule*, 62 MICH. L. REV. 567 (1964); Wolfson, *Rule 10b-6: The Illusory Search for Certainty*, 25 STAN. L. REV. 809 (1973); Note, *The SEC's Rule 10b-6: Preserving a Competitive Market During Distributions*, 1967 DUKE L.J. 809.

111. [T]he Commission need not have shown that Jaffee actually intended to defraud the marketplace through his purchases. The rule proscribes and clearly defines a *practice* which had, prior to 1955, been used fraudulently to distort the over-the-counter market. Where the rule applies, its prohibition is absolute.

Jaffee & Co. v. SEC, 446 F.2d 387, 391 (2d Cir. 1971) (emphasis in original).

112. See, e.g., *id.* at 390.

disclosure and from those which require purposive manipulative conduct as an essential element of the offense.

Rule 10b-6 is especially pertinent to abuses in OTC trading because most OTC manipulation takes place in connection with securities distributions.<sup>113</sup> By prohibiting broker-dealers from engaging in potentially manipulative transactions during their participation in distributions, rule 10b-6 attempts to prevent manipulative schemes from ever starting. Efforts to achieve this goal, however, have not been entirely successful. Despite the apparently definite and enforceable prohibitions established by the rule, considerable uncertainty has arisen over its scope.<sup>114</sup> As a result, the rule has not provided broker-dealers with a clear standard by which to conduct their trading activities. Moreover, rule 10b-6 has been criticized as tending in certain situations to constrain legitimate and desirable market making activities, a consequence that is counter-productive to the ultimate purpose of the rule.<sup>115</sup>

The uncertainties surrounding rule 10b-6 stem largely from confusion about the meaning of the term "distribution." The definitional elasticity of the concept of distribution has evolved from attempts to identify precisely what transactions constitute distributions for purposes of applying the rule. Stock offerings registered pursuant to the 1933 Act are considered to be within the ambit of rule 10b-6 because of the substantial number of shares and purchasers involved and the merchandising efforts accompanying such offerings. This proposition was stated definitively in *Jaffee & Co. v. SEC*.<sup>116</sup> In that case, a secondary offering of 107,700 shares of common stock in an electronics company was registered under the Securities Act. The largest block of this stock, consisting of 27,500 shares, belonged to Jaffee, who was the dominant partner in Jaffee and Company. Although Jaffee sold only a single block of 3,500 shares several months after the effective date of the registration statement, he purchased a total of 7,700 shares at various times during the offering. Jaffee contended that he

113. E.g., SEC v. Cooper, 402 F. Supp. 516, 519 (S.D.N.Y. 1975) (to facilitate a "22,000 shares or none" underwriting); SEC v. Rega, [Current] CCH FED. SEC. L. REP. ¶ 95,222 (S.D.N.Y. 1975) (to facilitate a "3,000,000 or none" underwriting); SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 967 (S.D.N.Y. 1975) (to facilitate a "best efforts, all or none" underwriting); Halsey, Stuart & Co., 30 S.E.C. 106 (1949) (to facilitate the distribution of a "sticky issue"); Masland, Fernon & Anderson, 9 S.E.C. 338, 342 (1941) (to facilitate a "best efforts" underwriting); Barrett & Co., 9 S.E.C. 319, 324-5 (1941) (to raise the price of a security for a contemplated distribution).

114. See Wolfson, *Rule 10b-6: The Illusory Search for Certainty*, 25 STAN. L. REV. 809, 812 (1973).

115. See Jaffee & Co., SEC Securities Exchange Act Release No. 8866 (Apr. 20, 1970), [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77805 (opinion of Commissioner Smith, concurring in part and dissenting in part); Whitney, *Rule 10b-6: The Special Study's Rediscovered Rule*, 62 MICH. L. REV. 567, 585 (1964).

116. 446 F.2d 387 (2d Cir. 1971).

regarded the offering as a "shelf registration"<sup>117</sup> under which he intended to hold the shares for investment and perhaps eventual sale, and that the block of 3,500 shares was sold in an "unsolicited transaction."<sup>118</sup> Nevertheless, the court held that there was a clear violation of rule 10b-6. In the court's view, the "very registration of shares owned by him implied an intention to sell or distribute rather than to hold them for investment."<sup>119</sup>

In addition to offerings registered under the 1933 Act, unregistered offerings may also be subject to the restrictions of rule 10b-6, depending on the nature and magnitude of the offering. The standard test for determining whether an unregistered distribution constitutes a distribution within the scope of rule 10b-6 was expressed by the SEC in *Bruns, Nordeman & Co.*,<sup>120</sup> the leading case on this question:

Rule 10b-6 is applicable to all distributions whether or not subject to registration under the Securities Act and whether or not the conventional procedure of utilizing an underwriter or selling group is employed. The term "distribution" as used in Rule 10b-6 is to be interpreted in the light of the rule's purposes as covering offerings of such a nature or magnitude as to require restrictions upon open market purchases by participants in order to prevent manipulative practices. For these purposes a distribution is to be distinguished from ordinary trading transactions and other normal conduct of a securities business upon the basis of the magnitude of the offering and particularly upon the basis of the selling efforts and selling methods utilized.<sup>121</sup>

In *Bruns, Nordeman*, a broker-dealer sold blocks of stock in a sporting goods corporation on two separate occasions. The first sale consisted of 42,550 shares distributed through 35 salesmen to 136 private purchasers; on the second occasion, 61,515 shares were sold to two other dealers for retail distribution to their customers. On these facts, the SEC concluded that the selling broker-dealer "was engaged in what was obviously a distribution."<sup>122</sup> The most troublesome aspect of the *Bruns, Nordeman* test is attempting to draw the line between activities constituting a distribution and those which are merely ordinary trading transactions. Application of the test inevitably requires a case-by-case examination of the general criteria that the SEC considers in determining whether a distribution has occurred, and as a result no specific standards have been developed. Except in obvious cases involving vigorous merchandising efforts to sell relatively large blocks of shares to numerous purchasers, broker-dealers are offered

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117. *Id.* at 390.

118. *Id.*

119. *Id.* at 391.

120. 40 S.E.C. 652 (1961).

121. *Id.* at 660.

122. *Id.*

little definite guidance as to what activities will trigger the application of rule 10b-6.

A related problem, assuming the presence of a distribution, is determining when a distribution commences and when it terminates. The SEC has set up an extremely flexible framework for analysis by describing a distribution as "the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public."<sup>123</sup> There is, however, no specific indication in rule 10b-6 as to when the distribution process starts or stops. Determination of when the 10b-6 prohibitions attach and when they terminate is crucial to OTC market makers who often may engage in normal market making activities in the same securities that they distribute. To ensure compliance with the rule, a market maker would have to stop bidding for or purchasing a security once he became an underwriter or prospective underwriter of that security. Similarly, a broker-dealer would have to cease bidding and purchasing activities when he agreed to participate in a distribution. The precise time that a person has become a "prospective underwriter" or has "agreed to participate" in a distribution is, of course, uncertain and subject to varying interpretations.

Some certainty is provided with respect to distributions registered pursuant to the 1933 Act. In such cases, the general rule is that individuals involved in a registered distribution are required, at the latest, to cease all market making activities when the registration statement is filed.<sup>124</sup> The reach of rule 10b-6 is even greater in an unregistered distribution of the *Bruns, Nordeman* type in which the prohibitions of rule 10b-6 attach to a broker-dealer's market activities when plans for the distribution of a particular security are first seriously contemplated.<sup>125</sup>

Confusion has also arisen over the question of when a distribution is terminated. According to the test formulated by the SEC, a distribution is not completed until the block of securities being distributed "comes to rest in the hands of the investing public."<sup>126</sup> Under this standard, when a sale is made to persons whom the broker-dealer knows are purchasing for resale, the distribution is not completed until all the shares are resold and are in the possession of the individual investors. The 10b-6 prohibitions continue in other similar situations even though a distribution appears to be completed, such as when stock that has been sold is subsequently returned to the selling broker-dealer or when stock is "sold" to accounts that are effectively

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123. Oklahoma-Texas Trust, 2 S.E.C. 764, 769 (1937), *aff'd* 100 F.2d 888 (10th Cir. 1939).

124. See *Jaffee & Co. v. SEC*, 446 F.2d 387 (2d Cir. 1971).

125. The Federal Corporation, 25 S.E.C. 227, 230 (1947); see *Bruns, Nordeman & Co.*, 40 S.E.C. 652, 660 n.11 (1961); *Halsey, Stuart & Co.*, 30 S.E.C. 106, 124 (1950).

126. See note 123 *supra*.

under the control of the selling broker-dealer. The uncertainties inherent in determining the exact time when a distribution is deemed terminated for the purposes of rule 10b-6 are especially troubling to OTC broker-dealers since, upon termination of the prohibitions of the rule, it is likely that a broker-dealer who participated in the distribution would desire to commence market making activities in the security.

There is an important exception contained within rule 10b-6 that establishes a definite rule governing certain market activities of persons planning to participate in an OTC distribution. Proviso 11 states that rule 10b-6 shall not prohibit

purchases or bids by an underwriter, prospective underwriter or dealer otherwise than on a securities exchange, 10 or more business days prior to the proposed commencement of such distribution (or 5 or more business days in the case of unsolicited purchases), if none of such purchases or bids are for the purpose of creating actual, or apparent, active trading in or raising the price of such security.<sup>127</sup>

The rule also provides expressly that for the purpose of applying proviso 11, a distribution registered under the Securities Act of 1933 shall not be deemed to commence prior to the effective date of the registration statement.<sup>128</sup> Normal market making activities may, therefore, continue in a registered distribution until ten days prior to the effective date of the registration statement, provided that such activities are not intended to create actual or apparent trading in or to raise the price of the security planned for distribution. Participants in an unregistered distribution may continue their normal market making activities, subject to the same limitations on purposive manipulation applicable to registered distributions, until ten days before the distribution actually commences.

Although proviso 11 appears to set definite limits to the application of rule 10b-6 prior to a distribution, its carefully qualified language fails to provide certainty with respect to when the *per se* anti-manipulative prohibitions of the rule attach, and, therefore, when normal market making activities must cease. Since rule 10b-6 was designed to be a strict liability provision,<sup>129</sup> it was intended to relieve the SEC of the difficult and elusive task of establishing manipulative intent. Proviso 11, however, interjects indirectly the element of intent into the application of the rule by requiring, in effect, that the Commission prove a manipulative purpose behind any market transactions completed ten days or more before the commencement of a distribution. Consequently, underwriters and dealers continue to be

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127. 17 C.F.R. § 240.10b-6(a)(3)(xi) (1975).

128. *Id.*

129. For an excellent discussion of the strict liability concept underlying rule 10b-6, see Wolfson, *Rule 10b-6: The Illusory Search for Certainty*, 25 STAN. L. REV. 809 (1973).

vulnerable under 10b-6 to charges of engaging in purposively manipulative activities, regardless of whether such activities occur before the period carved out by the proviso. For example, a principal market maker participating in a distribution would not be protected by proviso 11 if the SEC enforcement authorities could establish that he had entered quotations prior to the ten-day period for the purpose of artificially raising the price of the security.

Proviso 11, then, creates a limited exception to the application of rule 10b-6 which may have the effect of involving the SEC in time- and resource-consuming efforts to prove that activities covered by the clause were "for the purpose of creating actual, or apparent, active trading in or raising the price of"<sup>130</sup> the security to be distributed. Moreover, because the proviso may serve to preclude *per se* application of the prohibitions of rule 10b-6 to transactions completed before the ten-day period, liability under the rule may not attach early enough in some situations to prevent a successful manipulation in contemplation of a distribution. For example, a prospective underwriter desiring to inflate the price of a security to set the stage for a later distribution at an artificially high price could avoid at least *per se* application of rule 10b-6 simply by manipulating the price of the security more than ten days in advance of the effective date of the registration statement or of the actual distribution in the case of an unregistered distribution, with the aim of inducing other broker-dealers to continue quotations at the inflated prices during the distribution. From the point of view of the SEC enforcement authorities, having to prove purposive manipulative conduct destroys the advantage of a *per se* anti-manipulative rule. Underwriters and dealers, on the other hand, continue to face uncertainty as to when market making activities prior to a distribution will trigger the application of rule 10b-6. In short, the uncertainty surrounding the rule, the possible ways of avoiding its *per se* prohibitions, and the element of intent introduced by proviso 11 all serve to erode the prophylactic advantages and value of the rule.

Along with the uncertainties that have arisen over the scope and application of rule 10b-6, the rule also has the unfortunate effect of hampering legitimate market making activities under certain circumstances. This untoward effect may occur when, as often happens in the OTC marketplace, the principal market maker in a security participates in a distribution of the security. Since the principal market maker is usually known in the trade as the person from whom shares of the security can be obtained, he is the person most likely to assist or manage the distribution. If he is required to cease normal market making activities for an indeterminate period of time before and during a distribution, holders of the security could be faced with

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130. 17 C.F.R. § 240.10b-6(a)(3)(xi) (1975).

serious liquidity problems. His withdrawal from the market and the ensuing reduction in demand for the security could trigger a significant price decline or even deprive holders of any market at all. This problem is especially acute in the OTC marketplace where investor demand often results from the merchandising efforts of an interested broker-dealer. In addition to the problem of preventing normal market making activities by a broker-dealer who is participating or proposes to participate in what is clearly a distribution, legitimate broker-dealer merchandising activities may be constrained by anxiety on the part of OTC broker-dealers that particular selling efforts on their part will be characterized as distributions under the *Bruns, Nordeman* test. In this respect too, the rule as presently construed makes legitimate merchandising efforts unduly vulnerable to SEC scrutiny and unnecessary regulation. This result runs counter to the interests of participants in OTC trading, including issuers, investors, and broker-dealers. One commentator has appraised this drawback of rule 10b-6 in the OTC context as follows:

It is not difficult to conclude that the rule, in its present form, applies literally with all its rigor to the OTC example. It is more difficult to conclude, in the light of the need for—and the needs of—the OTC market, that this result is altogether in the public interest.<sup>131</sup>

### C. Appraisal of Regulation of OTC Market Manipulation

#### 1. Deficiencies

The fundamental objectives of legislation currently governing the securities industry are to provide open and orderly markets, to establish competitive pricing mechanisms, and to ensure that the millions of investors using the exchange and OTC markets are protected from fraud and overreaching.<sup>132</sup> These objectives reflect congressional concern, generated principally by the investigation of the 1929 market collapse, for the vital role that the securities industry plays in our economy.<sup>133</sup> The maintenance of investor confidence in the securities markets is, of course, essential to the vitality of the present system of capital allocation. Only by protecting "those who do not know market conditions from the overreachings of those who do"<sup>134</sup> can the securities industry continue to attract individual and institutional investment capital. A thorough evaluation of the securities regulatory scheme, therefore, depends primarily on the extent to which regula-

131. Whitney, *Rule 10b-6: The Special Study's Rediscovered Rule*, 62 Mich. L. Rev. 567, 585 (1964).

132. See Securities Acts Amendments of 1975 § 2, codified at 15 U.S.C.A. § 78b (Supp. IV, 1975), amending Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1970).

133. See text accompanying notes 39-46 *supra*.

134. Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943).

tion has protected investors from fraudulent and manipulative practices that interfere with the natural interplay of supply and demand.

Although an extensive body of rules and regulations has developed pursuant to the laws governing the securities industry generally, the OTC market lacks a comprehensive regulatory scheme to prevent the specific abuses to which the OTC market is especially vulnerable. The bulk of the existing statutes, rules, and regulations which relate to OTC trading activities are based either on antifraud principles or on the philosophy of disclosure. Both of these approaches have inherent limitations in preventing manipulative practices. Under the antifraud statutes and rules, the burden of proving manipulative intent impedes and often frustrates SEC enforcement efforts. Statutes based on disclosure suffer inevitably from noncompliance by broker-dealers who engage in market manipulation. Furthermore, as pointed out in the Commission's *Special Study of the Securities Markets*,<sup>135</sup> the emphasis on fraud and disclosure has proved to be effective principally in cases "discovered only *after* some public investors have been victimized so that the best that can be done is to protect others from becoming victims."<sup>136</sup> The *Special Study* also pointed out that the antifraud approach, with its emphasis on disclosure, has been effective primarily in flagrant cases of manipulation.<sup>137</sup> The blatantly manipulative pools and corners that once flourished have been eliminated for the most part by the securities acts, however, and it is the more subtle forms of manipulation that continue to plague the securities markets.<sup>138</sup> Moreover, the OTC market is particularly susceptible to these increasingly subtle manipulative practices that go unnoticed in the great volume of transactions conducted daily.

Rule 10b-6<sup>139</sup> is an exception to the more general prohibitions embodied in the antifraud and disclosure provisions in that it establishes a relatively specific prohibition, violation of which is *per se* manipulative. The principal advantage of the strict liability approach of rule 10b-6 is that it relieves the SEC of the difficult task of proving manipulative or fraudulent intent. Rule 10b-6, however, is both under- and over-inclusive since it governs only the practices of persons engaging in distributions, and since it may hinder legitimate market making activity during distributions.

In contrast to the generality of the provisions regulating trading activity on the OTC market, trading on exchange markets is controlled by a detailed regulatory structure. For example, the complex and thorough set of rules governing stock exchange specialists, key figures in the conduct of trading on the exchange markets, is designed

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135. See note 5 *supra*.

136. SPECIAL STUDY, *supra* note 5, pt. 2, at 655.

137. *Id.*

138. See 6 Loss (Supp. 1969), *supra* note 32, at 3762.

139. 17 C.F.R. § 240.10b-6 (1975).

to prevent them from abusing their unique positions of influence.<sup>140</sup> Rule 11b-1<sup>141</sup> promulgated under the Exchange Act requires the national exchanges to formulate specific rules obligating a specialist to "engage in a course of dealings for his own account to assist in the maintenance, so far as practicable, of a fair and orderly market" and to restrict his dealings "so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market."<sup>142</sup> The first requirement, that the specialist must participate in the market for his specialty stock, has been termed his "affirmative obligation."<sup>143</sup> The second requirement, that the specialist must limit his market making activities to those which will ensure a fair and orderly market, is more in the nature of a restriction, and accordingly has been termed the specialist's "negative obligation."<sup>144</sup> Both the New York and American Stock Exchanges have enacted rules to enforce these obligations.<sup>145</sup> To ensure compliance with the rules, the SEC and the exchanges have formulated detailed standards of performance and sophisticated monitoring techniques.<sup>146</sup>

## 2. *Securities Reform Act of 1975*

The regulatory structures of the exchange and OTC markets face the certain prospect of a major overhaul due to the recent enactment of the Securities Reform Act of 1975.<sup>147</sup> In broad terms, the Reform Act is an effort to create a new market system that will be controlled to an increasing degree by unfettered competition.<sup>148</sup> The SEC's first

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140. In his unique capacity the specialist stands at the heart of the Exchange market mechanism. He has intimate knowledge of the past market action of the stocks in which he specializes. He also has sole access to the specialist book showing outstanding orders both below and above the market, which affords him a great competitive advantage over the public. In addition, he exercises a significant influence on the public appraisal of a security, since he is the one who quotes the market.

SEC, STAFF REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE 23 (1962).

For thorough discussions of the role of the exchange specialist, see SPECIAL STUDY, *supra* note 5, pt. 2, at 57-171; Graham & Wheeler, *The Specialist Firm in The Stock Market* HANDBOOK 911 (F. Zarb & G. Kerekes eds. 1970); Wolfson & Russo, *The Stock Exchange Specialist: An Economic and Legal Analysis*, 1970 DUKE L.J. 707; Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N.Y.U.L. REV. 695 (1967).

141. 17 C.F.R. § 240.11b-1 (1975).

142. 17 C.F.R. § 240.11b-1(a)(2)(ii), (iii) (1975).

143. SENATE SECURITIES INDUSTRY STUDY REPORT, *supra* note 4, pt. 4, at 8.

144. *Id.* at 6.

145. N.Y. STOCK EXCHANGE, N.Y. STOCK EXCHANGE CONSTITUTION AND RULES, rule 104, at ¶ 2104 (May 1, 1972). AMERICAN STOCK EXCHANGE, AMERICAN STOCK EXCHANGE CONSTITUTION AND RULES, rule 170, at ¶ 9310 (June 1, 1975).

146. See SPECIAL STUDY, *supra* note 5, pt. 2, at 101-110, pt. 4, at 524-26, 547-54.

147. Securities Acts Amendments of 1975 §§ 2-31, codified at 15 U.S.C.A. §§ 78a-kk (Supp. IV, 1975), amending Securities Exchange Act of 1934 §§ 1-34, 15 U.S.C. §§ 78a-hh (1970).

148. See SENATE REPORT ON SECURITIES ACTS AMENDMENTS OF 1975, *supra* note 36,

priority is to eliminate unnecessary regulatory restrictions that currently hinder free competition and impede the market's natural economic processes.<sup>149</sup> Consistent with this general philosophy, the Reform Act amended section 11(b)<sup>150</sup> of the Exchange Act to eliminate the negative obligation imposed on the stock exchange specialist. The specialist's affirmative obligation has been maintained, but, as indicated by the Senate Report on the Reform Act,<sup>151</sup> increased competition among market makers "should supplement, and ultimately may be able to replace, most affirmative requirements to deal imposed by regulation."<sup>152</sup>

These basic changes made by the Reform Act initially appear to reduce the SEC's rulemaking and regulatory role. Examination of the Senate Report on the Reform Act reveals, however, that this proposition is only half correct. While the Reform Act postulates free competition as an ideal, the Senate Report indicates that the SEC must play a much larger role than it has in the past to ensure that the freely competitive market ideal is attained.<sup>153</sup> In those situations where natural competitive forces cannot be relied upon, the SEC must provide leadership for the development of a coherent and rational regulatory structure to police effectively trading activities.<sup>154</sup> The Senate Report makes it clear that the amended version of section 11(b) of the Exchange Act "broadens the Commission's rule making authority."<sup>155</sup> Under this expanded provision, the Commission may adopt rules as necessary to protect investors and to maintain fair and orderly markets.<sup>156</sup>

The SEC has also been given expanded rulemaking authority to oversee operations in the OTC market. Section 15(c)(5),<sup>157</sup> a new provision added to the Exchange Act, empowers the SEC to regulate trading activities of market makers other than specialists registered on a national securities exchange. Under section 15(c)(5), the Commission has broad and flexible authority to regulate dealers and market makers as necessary to protect investors and to maintain open markets. The principal reason for the SEC's expanded rulemaking authority is the inherent inability of the statutory scheme to anticipate particular abuses that may arise in the securities industry. In

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at 7-8, 14-16.

149. *Id.* at 2.

150. 15 U.S.C. § 78k(b) (1970).

151. See note 148 *supra*.

152. SENATE REPORT ON SECURITIES ACTS AMENDMENTS OF 1975, *supra* note 36, at 14.

153. *Id.* at 2.

154. *Id.*

155. *Id.* at 15.

156. *Id.*

157. Securities Acts Amendments of 1975 § 11, codified at 15 U.S.C.A. § 78o(c)(5) (Supp. IV, 1975), amending Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o(c) (1970).

order to police adequately the changing methods of trading, the SEC must be able to define and restrain activities that interfere with free competition. The need for this latitude in rulemaking is made clear in the Senate Report:

The Committee has made no determination as to what, if any, limitations or obligations should be imposed on non-specialist market makers. However, the SEC has indicated that certain obligations may be appropriate, and this provision would provide the agency with sufficient authority over all market-making and positioning functions to insure open and fair competition among dealers and the maintenance of fair and orderly markets.<sup>158</sup>

The Reform Act thus creates a tension between the philosophy of free competition and the need for detailed regulation where competition does not adequately protect investors. To ensure that this tension is not stretched toward the side of unnecessary regulation, the Committee that formulated the Reform Act indicated that the SEC must refrain from imposing any new regulatory burdens not necessary or appropriate to further the purposes of the Exchange Act.<sup>159</sup> Accordingly, any rules promulgated by the Commission must be drawn precisely and applied carefully, reaching only the evil to be prevented.

## II. PROPOSED RULES

### A. *Prohibition of Unwarranted Price-Raising*

According to classical economic theory, the price of a commodity on a perfectly functioning market is determined solely by the demand for the commodity operating against the supply available for trading.<sup>160</sup> Conceptually, a securities market approximates closely the economist's model of a "perfect" market: the commodities traded (shares of corporate stock) are fungible, there are many potential buyers and sellers, and there is complete freedom to enter and leave the market.<sup>161</sup> Prices on the securities markets, therefore, should ideally be determined by the collective judgment of buyers and sellers in arm's length transactions.<sup>162</sup>

Although a trading environment where prices are determined solely by forces of supply and demand is appealing in its theoretical simplicity and symmetry, the OTC market does not always conform to

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158. *Id.* at 722-23.

159. *Id.* at 615.

160. See W. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY 4-5 (1965); W. EITEMAN, C. DICE & D. EITEMAN, THE STOCK MARKET 8-15 (4th ed. 1966); R. WEST & S. TINIC, THE ECONOMICS OF THE STOCK MARKET 16-45 (1971).

161. See Pozen, *Competition and Regulation in the Stock Markets*, 73 MICH. L. REV. 317, 350 (1974).

162. Norris & Hirshberg, Inc., 21 S.E.C. 865, 881 (1946). See *Market-Makers, Manipulators and Shell Games*, *supra* note 19, at 597, 609 n.41. In certain well-defined situations, however, some interference with the free operation of the forces of supply and demand is permitted. See, e.g., SEC rule 10b-7, 17 C.F.R. § 240.10b-7 (1975).

this model. Price manipulation by market makers is the major factor that derogates from this ideal. When one person or group of persons is able artificially to influence the level or direction of prices, then the market is no longer freely competitive. The most common form of price manipulation on the OTC market is the practice of raising the bid prices of a security when there is no actual demand to support the price rise.<sup>163</sup> Merely by entering successively higher bids, a market maker can singlehandedly generate the illusion that there is a rising independent market for the stock. The increasingly higher quotations may "persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage."<sup>164</sup> This impression may also arouse the interest of other brokers and dealers. The potential for price manipulation in such a situation threatens to undermine a fundamental assumption of investors that the bid and asked quotations for a security accurately reflect the value of that security as determined by the composite impact of competitive buying and selling transactions. If two or more broker-dealers conspire to insert inflated quotations for the price of a stock, the increased activity in the "pink sheets"<sup>165</sup> or on the NASDAQ reporting system<sup>166</sup> gives the

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163. See, e.g., SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970); Pennaluna & Co. v. SEC, 410 F.2d 861 (9th Cir. 1969); SEC v. Resch-Cassin & Co., 362 F. Supp. 964 (S.D.N.Y. 1973); J.H. Goddard & Co., 42 S.E.C. 638 (1965); Advanced Research Associates, 41 S.E.C. 579 (1963); Bruns, Nordeman & Co., 40 S.E.C. 652 (1961); Reynolds & Co., 39 S.E.C. 902 (1960); Sterling Secs. Co., 39 S.E.C. 487 (1959); Gob Shops of America, 39 S.E.C. 92 (1959); R.L. Emacio & Co., 35 S.E.C. 191 (1953); Floyd A. Allen & Co., 35 S.E.C. 176 (1953); Adams & Co., 33 S.E.C. 444 (1952); Halsey, Stuart & Co., 30 S.E.C. 106 (1949); M.S. Wein & Co., 23 S.E.C. 735 (1946); Masland, Feron & Anderson, 9 S.E.C. 338 (1941); Barrett & Co., 9 S.E.C. 319 (1941).

164. 3 Loss, *supra* note 32, at 1550.

165. The "sheets" are printed listings of certain securities traded on the OTC market. They identify the security, quote the bid and asked prices submitted by broker-dealers who subscribe to the service, and list the firm's telephone number. Dissemination of this information is essential to broker-dealers who wish to execute a transaction in an OTC stock listed in the sheets.

The sheets are published daily by the National Quotation Bureau, Inc., a subsidiary of the Commerce Clearing House. There are three editions, printed on different colored paper corresponding to three national geographic areas—Eastern, Midwestern, and Pacific. A particular security listed in the sheets generally appears in one of the three editions, depending on the geographic area in which that security is traded most actively. The Eastern listings, which contain the largest number of securities, are printed on pink paper and are referred to as the "pink sheets." For discussions of the role played by the sheets in OTC trading operations, see I. FRIEND, G. HOFFMAN & W. WINN, THE OVER-THE-COUNTER SECURITIES MARKETS 14-15 (1958); 2 Loss, *supra* note 32, at 1278-81; Burns, *Over-the-Counter Market Quotations: Pink, Yellow, Green and White Sheets—A Gray Area in the Law of Evidence*, 52 CORNELL L.Q. 262 (1967); Loomis & Rotberg, *Over-the-Counter Market Quotations*, 62 MICH. L. REV. 589 (1964).

166. NASDAQ, an acronym for the National Association of Securities Dealers Automated Quotation system, is a computerized system designed to facilitate trading on the OTC market. NASDAQ began operations on February 8, 1971. Broker-dealers subscribing to the system can obtain the most recent quotations submitted by market makers in NASDAQ-listed securities simply by querying a NASDAQ electronic ter-

appearance of an even broader and more active market for the stock than when only one broker-dealer manipulates the quotations.

Unwarranted price-raising is precisely the type of manipulative contrivance that the SEC must prevent in order to maintain free and open markets. Authority for a preventive rule in this area is found in section 15(c)<sup>167</sup> of the Exchange Act, as amended by the Reform Act. The amended version of 15(c) directs the Commission to "define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent."<sup>168</sup> Consistent with the spirit of the Act, however, any rules promulgated to prevent manipulative price-raising must be tailored carefully so as not to hamper legitimate trading activity.

A number of proposals addressing the problem of price manipulation have been made in recent years. One approach that has been advanced is to prohibit a market maker from entering a quotation for a security unless he has a reasonable and adequate basis for making that quotation.<sup>169</sup> If the market maker can show a positive reason for his quotation, his activity will be presumed not to be manipulative.

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rninal located in their offices. Actual execution of a buy or sell transaction is then conducted over the telephone.

NASDAQ encompasses three distinct "levels" of service. Level I is geared toward the retail customer. The service provides the retail broker with a quotation on a particular security which represents the median quotation of all the prices submitted by market makers in that stock. Price changes fed into the system will be reflected in the desk top Level I terminals within five seconds. Thus, customers enjoy the advantage of receiving a representative quotation from retail brokers instantly, rather than having to wait for the broker to contact one or more wholesale firms.

Level II service provides the retail broker-dealer with all of the current wholesale quotations in a designated security in groups of five, ranked according to the best prevailing bid or offer. The quotations are read from a screen similar to a television screen. Although the trader must still contact the market maker by telephone, NASDAQ Level II service eliminates the preliminary phone calls that were previously necessary to determine the best market.

Level III service is similar to that of Level II but provides an added feature which allows market makers to enter a market or change a price that will ultimately be reflected on the Level II screen. Thus, Level III service is designed for market makers only. One safeguard built into the NASDAQ system is that market makers may enter quotations for only those stocks for which they have prior authorization from the NASD. The NASD also provides that Level III users must meet certain net capital requirements.

For discussions of NASDAQ, see Pozen, *Competition and Regulation in the Stock Markets*, 73 MICH. L. REV. 317, 318-20 (1974); Wolfson, Rosenblum & Russo, *The Securities Markets: An Overview*, 16 HOW. L.J. 791, 821-23 (1971).

167. Securities Acts Amendments of 1975 § 11, codified at 15 U.S.C.A. § 78o(c)(1) (Supp. IV, 1975), amending Securities Exchange Act of 1934 § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1970).

168. *Id.*

169. Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969), citing SEC Securities Exchange Act Release No. 6721 (Feb. 2, 1962). See Martin, *Broker-Dealer Manipulation of the Over-the-Counter Market—Toward a Reasonable Basis for Quotations*, 25 BUS. LAW. 1463 (1970); Comment, *Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 719, 813 (1975).

Under this approach, the bid quotation submitted for a security must be reasonably based on the merits of the investment. Another proposal which is closely related to the "reasonable basis" approach is the recent recommendation made by the SEC Advisory Committee on the Implementation of the Central Market System. The Advisory Committee's recommendation was that

[a]ll specialists and market makers would be required to have competitive two-sided quotations for each security in which they are making a market; such quotations must bear a reasonable relation to the specialist's or market maker's last sale in such security.<sup>170</sup>

The requirement that the quotation a market maker submits for each security in which he is making a market must bear a reasonable relation to the market maker's last sale of such security would cause the market maker's quotations for a security to be dependent on the actual demand for that security. In this sense, the "reasonable basis" and "reasonable relation" proposals strive for the same goal—to ensure that stock prices are the result of natural economic forces rather than manipulative schemes.

The fact that both proposals focus on price quotations as the means of regulating price manipulation illustrates that the most important item of information about a given security is its price as quoted by broker-dealers. All other information about the security, the issuer, or the market for the security enters into the determination of price. Because price is, in this sense, the ultimate fact, a misrepresentation of the price of a security is the most serious impediment to the maintenance of fair and honest securities markets.

Accurate price setting is especially important in the OTC market system. In contrast to the centralized operation of the exchanges, the OTC market consists of a diverse and widespread network of broker-dealers who conduct trading by telephone.<sup>171</sup> The OTC market is frequently characterized by a lack of competitive forces operating on the securities being traded. It is not unusual for a single market maker to be able to control and dominate the market in a certain security and thus set a price free, or relatively free, from the forces of supply and demand.

There are several problems with both the "reasonable basis" approach and the SEC Advisory Committee's "reasonable relation" proposal. First, enforcement by SEC surveillance and disciplinary action would be difficult, even in the light of the improved ability of the SEC to detect manipulated price rises. The test of "reasonable-

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170. [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,135 (Recommendations on the Implementation of the Central Market System by SEC Advisory Committee "Working Groups").

171. For detailed study of the OTC market system, see I. FRIEND, G. HOFFMAN & W. WINN, THE OVER-THE-COUNTER SECURITIES MARKETS (1958); SPECIAL STUDY, *supra* note 5, pt. 2, at 541-796.

ness" is inherently elastic, and the resulting uncertainty would impede SEC enforcement efforts under either the "reasonable basis" or the "reasonable relation" rule. By the same token, these proposals fail to provide broker-dealers with definite and ascertainable standards by which to measure the legality of their conduct.

The uncertainties of the "reasonable" test can best be avoided through a rule that establishes definite requirements to be followed in submitting quotations, violation of which would be deemed manipulative per se. Accordingly, it is proposed that the Commission adopt a rule that would prohibit an OTC market maker from raising his bid price in a security until there had been a legitimate transaction in the security at a price in excess of his current bid.<sup>172</sup> Further, the market maker should not be allowed to raise his bid above the price at which the subsequent transaction was executed. This proposal would combat the manipulative practice of entering successively higher bids in the absence of bona fide demand for a security.

Assume, for example, that a market maker has entered quotations of \$19 bid and \$21 asked. Under the proposed rule, the market maker will not be allowed to raise his bid price above \$19 until there has been a transaction in the security at a price in excess of \$19. Once a sale occurs at a price higher than \$19, the market maker could raise his bid price commensurately. Thus, if there were a sale at \$20, the market maker would be able to raise his bid to \$20. By preventing the market maker from unilaterally inflating the price of a security, the rule would ensure that the security's price would rise only when there was actual demand for the security.

The price-raising scheme involved in *Barrett & Co.*<sup>173</sup> illustrates how the proposed rule could be applied in practice. In *Barrett*, the SEC instituted disciplinary proceedings against three OTC brokers and dealers for violating section 15(c)(1)<sup>174</sup> of the Exchange Act and rule 15c1-2<sup>175</sup> in connection with manipulative trading practices in the common stock of the American Wringer Company. Barrett and Company was the primary market maker in the stock. The firm entered initial quotations in the daily sheets of 4½ bid and 5¾ asked. In the next three months, the firm entered quotations at increasingly higher levels to an eventual high of 10½ bid and 11½ asked. At various times during this period, the quotations entered by the Barrett firm

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172. The intervening transaction may be executed by any market maker dealing in a particular security. If a transaction is executed by the market maker who wants to raise his bid, he of course will have first-hand knowledge of the transaction. For purposes of this rule, it will be necessary to allow market makers to rely on an increased bid appearing in the quotation sheets as evidence of a transaction which would allow a higher bid to be entered. Cf. *Halsey, Stuart & Co.*, 30 S.E.C. 106, 127 (1949).

173. 9 S.E.C. 319 (1941).

174. Securities Exchange Act of 1934 § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1970).

175. 17 C.F.R. § 240.15c1-2 (1975).

were higher than the bid and asked quotations of any other firm appearing in the sheets. Two other firms joined Barrett toward the end of the manipulation period and assisted in the price-raising scheme by entering successively higher quotations. The court concluded that the firms, by raising continually their bids and buying at the higher bid prices, manipulated the price of American Wringer common stock "with the intent of raising the price in order to induce the purchase of the stock by others."<sup>176</sup> Transactions of this character operated "as a fraud or deceit"<sup>177</sup> and thus violated section 15(c)(1) of the Exchange Act and rule 15c1-2.

Application of the proposed rule prohibiting unwarranted price-raising to the *Barrett & Co.* case would differ from application of section 15(c)(1) and rule 15c1-2 in one essential respect. In contrast to these provisions, the proposed rule would not require the SEC to establish manipulative intent. The principal advantage of this approach from the standpoint of the enforcement authorities is that the rule defines and prohibits a specific practice deemed to be manipulative per se. To make out a violation, the SEC would only have to establish that a broker-dealer raised his bid price without any intervening legitimate transaction to justify the price rise.

This approach to preventing price manipulation is modeled on the theory behind rule 10b-6,<sup>178</sup> which imposes strict liability for the commission of certain practices defined to be manipulative per se. But unlike rule 10b-6, the proposed rule prohibiting unwarranted price-raising would not hamper legitimate dealer activity. In a perfectly functioning market, a market maker would not raise his bid price unless he was able to sell the stock at a price higher than his bid price. If the market maker misjudges the public demand for an issue and enters an initial bid quotation that is too low, his asked quotation will probably also be too low, and he will soon be able to raise his bid following a sale at his attractive asking price. If his initial bid is too low but his initial asked is accurate or even too high for current market demand, he will have to delay raising his bid until there is a sale at a price in excess of his bid. But eventually the normal operations of supply and demand will set bid and asked quotations at levels that accurately reflect market conditions. In this respect, the rule aligns market making activity with the natural economic process of demand operating upon supply, which ideally determines prices on a free and open market.<sup>179</sup>

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176. 9 S.E.C. 319, 328 (1941).

177. *Id.*

178. 17 C.F.R. § 240.10b-6 (1975).

179. [T]he market is not a weighing machine, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities. Rather should we say that the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion.

A market maker may, of course, always leave the market by withdrawing his bid and asked quotations for a stock. The proposed rule could accommodate withdrawals from the market by allowing the market maker to re-enter his quotations at the end of a specified period of time, perhaps ten business days, without regard to his previous bid. The raising of bid prices at ten-day intervals, unsupported by quotations during the absent period, would not provide the kind of continuous price-raising necessary for an effective manipulation. Moreover, a ten-day absence proviso to the proposed rule would afford some flexibility to the rule's strict prohibition.

### B. Limitation on Accumulation of Inventory

Stock prices are determined, for the most part, by the law of supply and demand. A fundamental element of most price manipulations is the intentional distortion of the apparent demand for the stock being manipulated. Demand distortion is frequently accompanied by a planned restriction of the supply of that stock on the market. The combined effect of limiting the supply available for trading and entering artificially high quotations enhances the overall manipulative effect of the scheme.

Distortion of the "supply" factor in the law of supply and demand occurs typically when a broker-dealer accumulates an excessive inventory of shares in the stock being manipulated.<sup>180</sup> The sudden "drying up"<sup>181</sup> of the supply prior to and during the manipulation causes the existing demand to have an exaggerated effect on the stock's price. To counteract this element of price manipulation, a rule restricting the amount of inventory that can be held by market makers is necessary to complement the proposed rule prohibiting the unwarranted raising of bid quotations.

Normal dealer operations require that a market maker maintain a certain minimum inventory level of the securities in which he is making a market.<sup>182</sup> OTC market makers generally prefer to operate with low inventories because of the possibility of a falling market: the lower the inventory, the less risk the market maker runs of suffering loss due to decline in the market value of the security. The dealer looks primarily to his "jobber's turn" for a profit, and only rarely to

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B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 42 (4th ed. 1962).

180. E.g., Bruns, Nordeman & Co., 40 S.E.C. 652 (1961); Gob Shops of America, Inc., 39 S.E.C. 92 (1959); The S.T. Jackson & Co., 36 S.E.C. 631 (1950); R.L. Emacio & Co., 35 S.E.C. 191 (1953); Halsey, Stuart & Co., 30 S.E.C. 106 (1949); M.S. Wein & Co., 23 S.E.C. 735 (1946); Masland, Fernon & Anderson, 9 S.E.C. 338 (1941); Barrett & Co., 9 S.E.C. 319 (1941).

181. Barrett & Co., 9 S.E.C. 319, 327 (1941).

182. For a detailed study of inventory practices of OTC dealers, see I. FRIEND, G. HOFFMAN & W. WINN, THE OVER-THE-COUNTER SECURITIES MARKETS 245-308 (1958).

appreciation in market value of stock held in inventory.<sup>183</sup> Other significant factors that discourage high inventory accumulation are the low capitalization of many OTC market makers and the legal restrictions on indebtedness.<sup>184</sup>

A market maker accumulates his inventory of a certain stock from the "floating supply" of the stock available on the market. The floating supply is essentially that portion of the issue which is held by dealers and by the public for profitable resale,<sup>185</sup> as distinguished from the part of the stock held for longer-term investment. In marked contrast to normal dealer inventory practices, the market maker intending to manipulate the price of a stock will often try to dry up the floating supply by accumulating substantial amounts of the stock in his inventory. The market maker may buy the stock and hold it in his own account or place it in accounts that are subject to his authorized or de facto control. Accounts set up for family members, friends, and business associates are typical havens used to disguise the full extent of inventory the market maker has under his control.<sup>186</sup> Customer accounts over which the market maker has been granted discretion, as well as non-discretionary customer accounts over which he has gained de facto control, have also been used to hide inventory accumulations.

The accumulation of a substantial portion of the floating supply of a stock is usually an integral part of manipulative price-raising schemes. By buying enough stock to capture control over the floating supply, a dealer can restrict the number of shares available for trading. The existing demand operating on this restricted supply facilitates a rise in price. The *Barrett & Co.*<sup>187</sup> case illustrates the fundamental interplay of supply and demand that takes place in market price manipulations. As discussed previously,<sup>188</sup> the offending broker-dealers in Barrett engaged in a plan to inflate artificially the price of the common stock of American Wringer. During the quotation-raising program, the broker-dealers involved in the manipulation acquired a substantial portion of the floating supply of the stock. Although there were 111,000 shares of the stock outstanding, only about 10% of these

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183. Since the wholesale dealer usually expects to make its entire profit out of the spread, it usually attempts to keep inventories low in order to minimize the effects of price fluctuations. Most transactions are executed by market makers on an incoming basis, and only occasionally will a wholesale dealer initiate a transaction, since it would ordinarily mean purchasing at another dealer's offer or selling at another dealer's bid.

SPECIAL STUDY, *supra* note 5, pt. 2, at 564.

184. See SEC rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1975); I. FRIEND, G. HOFFMAN & W. WINN, THE OVER-THE-COUNTER SECURITIES MARKETS 256-58 (1958).

185. *Barrett & Co.*, 9 S.E.C. 319, 327 n.8 (1941). See J. FLYNN, SECURITY SPECULATION: ITS ECONOMIC EFFECTS 130-34 (1934); 3 LOSS, *supra* note 32, at 1555-60.

186. See SPECIAL STUDY, *supra* note 5, pt. 1, at 528.

187. 9 S.E.C. 319 (1941).

188. See text accompanying notes 173-77 *supra*.

shares were available in the floating supply. The rest were held by long-term, relatively permanent investors. Barrett, the primary market maker in the stock, normally maintained a trading position that did not exceed 1,500 shares. During the course of the manipulation, however, the firm accumulated an additional 4,800 shares, 48% of the estimated floating supply of 10,000 shares. The court found that the consequent diminution of the floating supply of stock "undoubtedly served to facilitate that [price-raising] program."<sup>189</sup>

A rule placing specific limitations on the amount of inventory that a market maker may hold at any one time would prevent him from obtaining a dominant position in a stock. In view of the normal inventory practices of most OTC dealers, restrictions on inventory accumulation would not appear to impose an undue burden on competition among market makers. Rather, consistent with the spirit of the Reform Act, an inventory rule would prohibit a clearly defined practice that has proven to be anti-competitive and marked by significant manipulative potential.

Difficult problems remain, however, in determining objective standards upon which to base the limitations on inventory accumulations. The starting point in formulating such standards is to determine the floating supply of any given stock issue. It is this supply of shares available for trading, as distinguished from the shares resting in long-term investment accounts, that exerts in the short run a controlling influence on the price level of a security.<sup>190</sup> Once the extent of the floating supply is established, the next step is to set definite limits to the portion of this supply that can be held by a market maker. The problem, then, is essentially to determine the number of shares in the floating supply and to establish what proportion of the supply a dealer may hold without creating manipulative potential.

Most investors and speculators have no practical means for determining what portion of an outstanding issue is in the floating supply. This information, however, is available to the SEC. The data necessary to determine the size of the floating supplies of OTC stocks could be compiled through existing SEC annual and periodic reporting requirements. Information in these reports revealing which individuals or firms were holders of the stock would enable the SEC to approximate the portion of the issue that was in the floating supply. The transfer agent of the issuer could supply this data, and it would not be an undue burden to include the information in the registration report and periodic reports.

The percentage of floating supply that would enable a dealer to exert undue influence over the price of a security varies tremendously according to the nature and size of the issue. For some issues, this amount may be a relatively small percentage of the floating supply.

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189. 9 S.E.C. 319, 327 (1941).

190. J. FLYNN, SECURITY SPECULATION: ITS ECONOMIC EFFECTS 130 (1934).

In *M. S. Mein & Co.*,<sup>191</sup> for example, a dealer had accumulated debentures with a face value of \$30,150 out of a total of \$392,500 worth of debentures outstanding. The dealer's rapid accumulation was found to have left other interested dealers without an adequate supply for normal operations. Consequently, the SEC found that the dealer, with an accumulation of little over 9% of the floating supply, had gained sufficient control over the supply to exercise a manipulative influence on the price level of the debentures. In other instances, a manipulating broker-dealer may accumulate a greater percentage of the floating supply of a stock to enable him to dominate and control the market for that stock. For example, in *SEC v. Resch-Cassin & Co.*,<sup>192</sup> a group of broker-dealers conspired to manipulate the price of a common stock. To facilitate this scheme, one of the dealers purchased over 50% of all the stock that came onto the trading market. Later, a confederate dealer acquired these shares, eventually accumulating approximately 22% of the entire issue. This variation in the percentage of the floating supply of a particular security that has given rise to manipulative potential must be considered in formulating a rule limiting inventory accumulation.

It is beyond the scope of this Article to undertake the kind of extensive and detailed study that would lead to a determination of objective standards for limiting the amount of inventory that a dealer could accumulate for normal operations. It is possible, however, to present in broad outline one approach to the problem. This approach is to examine instances where excessive accumulations of inventory have played a significant role in market manipulation. Such an examination would yield data showing specifically the portions of the floating supplies of various issues that have contributed to price manipulation. From this information, the SEC could determine the percentages of the floating supplies of various securities which had been found to be possessed of manipulative potential. These objectively derived figures could be adjusted upwards or downwards depending on how strict the SEC wished to make the prohibition of the rule. Although data could not, of course, be compiled for every security traded in the OTC market, securities possessing similar characteristics could be classified in a limited number of groups. Classification would depend basically on the size of the issuer, the number of shares outstanding, and the number of shareholders. The SEC could then establish prohibited levels of inventory accumulation applicable to all securities in a given group, rather than attempt to establish limitations to be applied to each individual security.

This process of determining the amount of shares of an issue that any one dealer could accumulate in inventory is admittedly crude and imprecise. Nevertheless, the rule does benefit from the certainty

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191. 23 S.E.C. 735 (1946).

192. 362 F. Supp. 964 (1973).

of its terms and application. This characteristic contrasts with the generality and vagueness that currently impair the effectiveness of many of the SEC's anti-manipulative rules and regulations.

Once applicable standards have been established, accumulation of inventory in excess of the limitations imposed would be deemed to be *per se* manipulative. The principal advantage of this approach is that it imposes strict liability for violation of the rule, and thereby relieves the SEC of proving manipulative intent or purpose. The fact that a broker-dealer had accumulated an amount of stock in excess of the maximum inventory allowed would trigger application of the *per se* proscription of the rule.

It will be necessary to exempt certain legitimate inventory accumulations from the strict application of the rule. The rule need not apply the same standards to all OTC dealers. There are certain situations where a dealer will have legitimate reasons for providing a deep and liquid market for a security. In such situations, it would be both necessary and desirable for a dealer to have substantial inventory accumulations. For example, a dealer who specialized in assembling blocks of stock for resale to purchasers desiring to acquire such blocks could be allowed to accumulate stock for that purpose if he were duly recognized as a "block dealer." In contrast to this type of legitimate dealer function, the build-up of inventory to provide enough shares for a dealer's sales force to merchandise is not the type of activity that would merit an exemption from the rule because such merchandise build-up often leads to "boiler room" operations<sup>193</sup> and other questionable selling practices.

### C. Scope and Enforcement of the Proposed Rules

A fundamental premise of the Reform Act is that free competition among market makers should supplement to an increasing degree regulatory restrictions as a means of maintaining fair and honest securities markets. To this end, changes in the institutional structure of the securities markets effected by the Reform Act are aimed largely at enhancing dealer competition. Active competition among dealers will reduce opportunities for dealer manipulation of prices and thereby afford greater protection of the investor.<sup>194</sup> If there are several market makers dealing independently in a particular security, the competition among them will generally ensure that the price of that

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193. See note 87 *supra*.

194. There has been much commentary regarding the benefits that will flow from increased dealer competition. See, e.g., SEC POLICY STATEMENT ON A CENTRAL MARKET SYSTEM, CCH FED. SEC. L. REP. No. 473 (Apr. 2, 1973); SEC POLICY STATEMENT, FUTURE STRUCTURE OF THE SECURITIES MARKETS, CCH FED. SEC. L. REP. No. 409 (Feb. 4, 1972), reprinted in 4 SECURITIES L. REV. 473 (1972); 1 INSTITUTIONAL INVESTOR STUDY, *supra* note 1; Baker, *Competition and Regulation: Charles River Bridge Recrossed*, 60 CORNELL L. REV. 159 (1975); Pozen, *Competition and Regulation in the Stock Markets*, 73 MICH. L. REV. 317 (1974).

security will be determined by the natural forces of supply and demand.

Healthy dealer competition, however, is not always possible in the OTC market. As the number of independent and active market makers decreases or as trading becomes concentrated in the hands of one particular market maker, opportunities for price manipulation increase. The *Special Study*<sup>195</sup> pointed out that the level of trading activity in different securities, although traded in the same market system, varies tremendously.<sup>196</sup> At one extreme on the OTC market are securities that are traded actively and that may be eligible for listing on an exchange; at the other extreme are securities that are traded so inactively that the markets for them fade in and out of existence. When public interest in a security is slight, or even nonexistent in some cases, a dealer has little incentive to make a market in that security. Consequently, no real dealer competition develops.<sup>197</sup>

Analysis of the reported OTC market manipulation cases and disciplinary proceedings reveals that in almost every instance, the market for the security being manipulated was extremely inactive prior to the manipulation.<sup>198</sup> It is precisely in these situations that the two rules proposed in this Article are most needed. Accordingly, these rules should be restricted in the scope of their application to only that segment of the OTC market where free competition cannot be relied upon to foreclose the opportunities for price manipulation. The problem, then, is to isolate the segment of the OTC market to which the proposed rules should apply. This task is perhaps best accomplished through a process of elimination.

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195. See note 5 *supra*.

196. SPECIAL STUDY, *supra* note 5, pt. 2, at 37.

197. The principal determinants of trading activity appear to be the number of shareholders and the number of shares outstanding. Demsetz, *The Cost of Transacting*, 82 Q.J. ECON. 33, 47 (1968). In a study of a sample of 1,618 OTC stocks studied in 1961, approximately one-half had fewer than 200,000 shares of their principal issue outstanding and fewer than 500 shareholders. SPECIAL STUDY, *supra* note 5, pt. 2, at 551. In contrast to these OTC stocks, only 2% of NYSE-listed issuers had fewer than 800 shareholders, and only 1% had less than 200,000 shareholders. *Id.* at 38.

198. See, e.g., SEC v. Management Dynamics, Inc., 515 F.2d 801, 805 (2d Cir. 1975) ("MD [Management Dynamics stock] had theretofore been traded only infrequently"); SEC v. D'Onofrio, [Current] CCH FED. SEC. L. REP. ¶ 95,201 at 98,014 (S.D.N.Y. 1975) ("Because the float of Galco stock was only 60,000 shares and trading until the previous day had been very light, the market reacted quickly to the active demand."); J.H. Goddard & Co., 42 S.E.C. 638, 639 (1965) (stock "was infrequently traded in the over-the-counter market" prior to manipulation); Bruns, Nordeman & Co., 40 S.E.C. 652, 655 (1961) (before manipulation, registrant was the only bidder in the sheets); The S.T. Jackson & Co., 36 S.E.C. 631, 651 (1950) ("trading in Columbia's common stock prior to [manipulation] was negligible"); Floyd A. Allen & Co., 35 S.E.C. 176 (1953) (prior to manipulation, quotations entered only in a local Los Angeles quotation service); Adams & Co., 33 S.E.C. 444, 447 (1952) ("market in Mohawk stock had been relatively dormant"). Masland, Fernon & Anderson, 9 S.E.C. 338, 342 (1941) ("shares were traded rather inactively over-the-counter").

So-called "third market" stocks, which are those stocks listed on a national securities exchange but also traded in the OTC system, should be excluded from application of the rules. Having met exchange listing requirements and being dependent upon exchange prices, third market stocks possess the characteristics that presumably ensure active and competitive markets.<sup>199</sup> Furthermore, there are at least two market makers for each third market stock—a stock exchange specialist and an OTC dealer.

OTC stocks listed in the NASDAQ system<sup>200</sup> also have characteristics that tend to ensure active markets, and thus healthy dealer competition. A minimum level of competition is established by the NASDAQ listing requirements, which require that generally there must be at least two market makers for each security listed on the NASDAQ system.<sup>201</sup> With the advent of the NASDAQ system, competing OTC market makers now convey their quotations in NSADAQ-listed stocks to other dealers electronically. The instant availability of the quotations enhances competition among market makers using NASDAQ and should reduce and eventually eliminate opportunities for price manipulation.<sup>202</sup> Like the third market stocks, NASDAQ-listed stocks should also be excluded from application of the proposed rules.

These two exempted segments of the OTC market system leave all those securities that are traded in what may be denominated the "residual" OTC market. It is this remaining segment of the OTC market, consisting of all securities traded OTC but which are not also traded on exchange markets or through the NASDAQ system, that is frequently characterized by low levels of trading activity and inadequate or non-existent dealer competition. These conditions in the residual OTC market provide the greatest opportunities for manipulation. Accordingly, the anti-manipulative rules that have been proposed in this Article should be limited to trading in residual OTC securities. This limitation comports with the SEC's oversight role under the Reform Act to adopt anti-manipulative rules only where natural competitive forces cannot be relied upon to protect investors.

## 2. *Enforcement*

An important characteristic of the rules proposed in this Article is that they can be enforced by the SEC without any showing of either fraudulent purpose or manipulative intent. Both the quotation-raising and inventory accumulation rules establish definite prohibi-

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199. See note 5 *supra*.

200. See note 166 *supra*.

201. *NASD By-laws*, schedule D (II)(A), CCH NASD MANUAL ¶ 1653A (1974). The average number of market makers per NASDAQ security in 1974 was 5.7. *NASD 1975 REPORT TO MEMBERS* 10.

202. See Wolfson, Rosenblum & Russo, *The Securities Markets: An Overview*, 16 How. L.J. 791, 822 (1971).

tions, violation of which is deemed manipulative per se. From the standpoint of the SEC enforcement authorities, the strict liabilities imposed by the rules could prove to be an effective means of preventing manipulative schemes that have become increasingly subtle and complex in recent years.<sup>203</sup> Enforcement of the proposed rule prohibiting an OTC broker-dealer from submitting successively higher quotations that are unsupported by legitimate intervening transactions would depend primarily on surveillance of the quotation "sheets" published by the National Quotation Bureau, Inc. All OTC securities that are not traded through the NASDAQ system are listed on the sheets. Daily distribution of the sheets enables subscribing broker-dealers to ascertain the latest bid and asked prices quoted by market makers. Because the residual OTC stocks are not listed on the NASDAQ system, the sheets are the essential means of maintaining surveillance over trading conduct in the residual OTC market. If an unusual trading situation develops, such as a sudden and unexplained fluctuation in the quotations for a particular OTC stock, an informal trading quiz<sup>204</sup> could then be instituted to determine whether the broker-dealer who submitted the quotations had violated the "intervening transaction" requirement of the rule.

The rule can be enforced most effectively against individual broker-dealers who unilaterally inflate the price of a stock through successively higher quotations. In these cases, proof of bid raising without an intervening transaction in the stock at a higher price constitutes manipulation per se. Application of the rule becomes more difficult when two or more broker-dealers conspire to inflate the price of a stock. Price manipulation effected through a group effort would tend to undermine the per se approach of the rule because the conspiring broker-dealers could arrange among themselves to execute the necessary intervening transactions to enable the principal manipulator or a collaborator to raise bid prices. Thus, for example, if broker-dealers A, B, and C conspire to inflate the price of a stock, A could enter initial quotations of \$19 bid and \$21 asked. B could then buy from A at \$21, and C could in turn buy from B at \$22, thereby enabling A to raise his bid accordingly. By buying and selling shares of the stock among themselves, the three manipulators could provide the necessary intervening transaction that serves under the rule as a condition precedent to bid-raising.

This manipulative practice is, of course, precisely the activity forbidden by rule 15c2-7,<sup>205</sup> which requires broker-dealers who are submitting quotations to an interdealer quotation system to identify any quotation that is submitted on behalf of another broker-dealer or in furtherance of certain arrangements between the submitting broker-

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203. See 6 Loss (Supp. 1969), *supra* note 32, at 3762.

204. See 3 Loss, *supra* note 32, at 1570.

205. 17 C.F.R. § 240.15c2-7 (1975).

dealer and other broker-dealers. Accordingly, regulation of conspiracies to manipulate prices will continue to depend primarily on compliance with rule 15c2-7, and the proposed rule to prevent artificial price-raising will have its principal impact in regulating unilateral manipulation executed by market makers acting individually.

The proposed rule restricting inventory accumulation could be enforced through SEC inspection of the books, records, and accounts maintained by OTC broker-dealers. The Commission may institute surprise inspections to determine if broker-dealers are violating any of the securities laws.<sup>206</sup> Difficulties in identifying nominal customer accounts over which a broker-dealer exercises effective control as part of his inventory position could be resolved through provisions imputing broker-dealer control over certain accounts. Through inspections, SEC officials could examine the inventory levels in the controlled accounts as well as the broker-dealer's own account. Periodic examination of all OTC broker-dealers' records, coupled with surprise inspections of any particular broker-dealers whose trading conduct may be suspect for one reason or another, would reveal whether any broker-dealer had accumulated an inventory of a security in excess of the limits established for that security.

#### IV. CONCLUSION

Although the antifraud provisions of the securities laws and the improved surveillance capabilities of SEC enforcement authorities have largely eliminated price manipulation on the exchange markets, this practice remains a problem in the OTC market system. A principal reason for the problem is that many of the securities traded in the OTC network have characteristics that enable market participants to influence or even control the market for a particular security. Major manipulations, such as those occurring in connection with a distribution or sale of a large block of stock, are frequently encountered in federal case law and SEC proceedings. Perhaps more disturbing are the frequent, often undetected, minor manipulations in which a market participant artificially inflates the price of a stock by a relatively small amount to obtain an extra profit. Both the flagrant abuses revealed by SEC investigations and enforcement proceedings and the less publicized but more pervasive minor price manipulations diminish investor confidence in the integrity of the OTC market operations.

Existing regulatory provisions, based for the most part on antifraud and disclosure principles, undoubtedly discourage much manipulative activity and afford redress in some individual cases. But these approaches have proven to be markedly deficient in preventing ma-

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206. See generally Ferrara, *SEC Division of Trading and Markets: Detection, Investigation and Enforcement of Selected Practices that Impair Investor Confidence in the Capital Markets*, 16 How. L.J. 950 (1971).

nipulative schemes at their inception, as opposed to providing a remedy after the damage has been done. The institutional structures and regulatory framework of the securities markets are, however, undergoing fundamental changes, as evidenced by the recent enactment of the Securities Reform Act of 1975. Through the development of a central market system and the implementation of an automated communications network designed to provide prompt and accurate trading information, the Reform Act strives for two paramount objectives—the maintenance of fair and orderly markets and the protection of investors. The fundamental premise of the Reform Act is that active competition among brokers and dealers will preclude opportunities for fraud and overreaching. In those situations where active competition will not ensure fair and honest markets, the SEC is empowered to promulgate rules governing trading activities. In view of the characteristics of a substantial proportion of the securities traded in the OTC system which make it unlikely that active dealer competition will develop, certain restrictions on OTC trading are necessary to effectuate the underlying purposes of the Reform Act.

This Article proposes two rules designed to prevent price-raising schemes through the unwarranted submission of successively higher quotations and excessive inventory accumulation. These two manipulative practices interfere with the natural interplay of supply and demand, which is the ultimate determinant of prices on a freely competitive market. By prohibiting the raising of quotations in the absence of legitimate demand and making illegal the accumulation of inventory by a market maker in excess of the actual needs of his business, the proposed rules aim to prevent artificial distortion of the supply and demand process. The most significant characteristic common to both rules is that they define and prohibit specific practices deemed to be manipulative *per se*. This strict liability approach avoids the difficulties inherent in enforcement of rules based on anti-fraud and disclosure principles under which the elusive element of intent must be established.

The scope of the rules has been carefully delimited to be consistent with the Reform Act's goal of achieving market regulation through the operation of freely competitive forces. Although there are difficulties in fashioning appropriate detection and enforcement procedures and in avoiding the imposition of any unnecessarily broad restrictions on market activities, the two rules address fundamental problems of market manipulation that continue to interfere with fair and honest trading in the OTC marketplace.

