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REGULATION OF STOCK MARKET MANIPULATION

AMONG the earliest and most important of the legislative programs of the Roosevelt administration was the reform of the securities markets. Support for the reform program was derived from the widespread belief that the market crash of 1929 was a prime cause of the ensuing depression and that fraud, manipulation and "excessive" speculation were the basic causes of the market crash.¹

In building the new regulatory system, which was embodied in the Securities Act of 1933² and the Securities Exchange Act of 1934,³ draftsmen and Congressional investigators groped for a working hypothesis about the

1. "... the fact emerges with increasing clarity that the excessive and unrestrained speculation which dominated the securities markets in recent years, has disrupted the flow of credit, dislocated industry and trade, impeded the flow of interstate commerce, and brought in its train social consequences inimical to the public welfare." SEN. REP. NO. 1455, 73rd Cong., 2nd Sess. (1934); see *Hearings before Committee on Interstate and Foreign Commerce on H. R. 7852*, 73d Cong., 2d Sess. (1934) (testimony of J. M. Landis).

2. 48 STAT. 74 (1933), 15 U. S. C. §§ 77a-77aa (1940).

3. 48 STAT. 881 (1934), 15 U. S. C. §§ 78a-78jj (1940), referred to hereafter as the Act or the 1934 Act and cited by section number only.

nature and effects of trading in securities.⁴ Speculation was contrasted unfavorably with investment. It was somehow felt that the purchase of securities for the expected change in their capital value was a less productive form of financial activity than the purchase of securities for dividends or interest payments. Yet economic theory accepted specialized risk-bearing as a useful and necessary function, and speculation was regarded as a productive force which shifted funds from the less to the more profitable areas and tended to harmonize money rates.⁵ Thus the organized market served its expected function of guiding the flow of capital funds to their most productive uses.

It was understood that the American securities markets were unique in the breadth of the public's participation,⁶ in the violence of their reactions, and in the extent to which they were regarded as a symbol of business activity. The difficulty with the functioning of the American markets, the economic observers agreed, was not speculation as such but the fact that the speculators were regularly stampeded into panicky fits of irrational optimism or pessimism, and that they were prone to prefer respectable conformity to independent judgment.⁷ Thus the inquiry into speculation as such was inconclusive. Whether the securities market caused the instability of the rest of the economy was not apparent. Even if it was conceded that market crashes disrupted the mechanism of finance, it was not at all clear that we could have a stable securities market in an unstable economy, and no theorist of the securities markets went so far as to contend that speculation in stocks was alone the cause of industrial fluctuations. The draftsmen lost interest in the search for a formula which would eliminate speculation and permit only long-term investment.

Yet the prejudice against speculation left traces in the new system for the

4. See generally *Hearings*, note 1 *supra*; *Hearings before Committee on Banking and Currency on Senate Resolutions 84 (72d Cong.) and 56 and 97 (73d Cong.)*, 72d Cong. and 73d Cong. (1932 and 1933) (the famous Senate investigation). On the connection between the market crash and general economic activity see KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* (1936) 150-9; ANGELL, *INVESTMENT AND BUSINESS CYCLES* (1941) 126, n. 1; SIMPSON, *THE MARGIN TRADER* (1938) 132-4.

5. Most theories of speculation were derived from the classical economic doctrines of the free market. Hardy, *Recent Developments in the Theory of Speculation* (1937) 27 AM. ECON. REV. (Supp.) 263; ROSS, *SPECULATION, STOCK PRICES AND INDUSTRIAL FLUCTUATIONS* (1939) c. 11. For a recent discussion of the proper place of speculation in a price-regulated economy see LERNER, *THE ECONOMICS OF CONTROL* (1944) c. 8. Generally it has been said that the function of speculation is to maintain market price at a reasonable equivalent to investment value or intrinsic value. Alternatively, it is sometimes said that maintenance of stability of market price is a function of speculation. These are not necessarily parallel functions; they may conflict. See ROSS, *supra*, at 189.

6. See Worcester, *Foreign and American Stock Exchanges* (1937) 8 AM. L. SCHOOL REV. 1058.

7. See KEYNES, *loc. cit. supra* note 4; GRAHAM AND DODD, *SECURITY ANALYSIS* (1934) 11; Address of David Saperstein, former Director of the Trading and Exchange Division of the S.E.C. in (1937) 8 AM. L. SCHOOL REV. 1066; Symposium, *Business, Speculation and Money* (1929) 13 ACAD. OF POL. SCI. PROC. No. 4.

control of the securities markets, particularly in the provisions for the control of margin trading and short selling. It is also to be found in the discrimination in the federal income tax law against short-term security transactions in favor of long-term holding.⁸ But control of speculation was not to be the central theme of the legislation. Much of the force which might have been directed at speculation itself was spent on the so-called "abuses" of the markets. Fraud in the sale of securities and manipulation in the markets were the twin objects of this drive. It was thought that if the abuses could be corrected, speculation as a whole could successfully perform the functions assigned to it by the classical economic theory.

Although the 1929 crash and the resulting investigations thus provided the impetus for the reform program, many of the details of the securities laws which resulted borrowed heavily from the background of the common law. This is particularly true with respect to the provisions aimed at fraudulent practices; to a large extent it can be said that the elimination of fraud was the purpose of the legislation. But at the same time there can be found a broader purpose—the regulation of activity which in some way conflicts with public interests other than protection against fraud. Although some precedent for the latter objective is to be found in the earlier law, particularly in the law of restraint of trade as applied to corners,⁹ it is largely a reflection of the later drive against speculation as a whole.

A complete survey of the influence of the reform program on the markets would include such topics as the credit controls,¹⁰ investment banking practices,¹¹ the full disclosure requirements and market manipulation. Recent developments in the markets have posed numerous questions about the efficacy of the regulatory system. In this comment it is proposed to single out for examination only one phase of the program—the control of manipulation. A judgment that the problem of manipulation has been successfully

8. Gains from the sale of securities held for less than six months are taxed in full; gains after a holding of more than six months are taxed at a maximum effective rate of 25%. INT. REV. CODE § 117 (1946).

9. See *infra* note 40.

10. Responsibility for the control of credit used for security speculation is lodged in the Federal Reserve Board. Sections 7,8 of the Act. For a recent discussion of the controls see Judson and Emerson, *The Effect of Regulation on Cash Transactions in Securities* (1946) 44 MICH. L. REV. 997. Effective January 21, 1946, the Federal Reserve Board forbade margin purchasing. This action has been attacked as unauthorized by the law, on the theory that the power to raise margin requirements was granted in order to prevent the diversion of credit from other uses to speculation, while the Board's action was taken at a time when there was no indication that ample credit was not available for all purposes. See Address by Emil Schram, President of the New York Stock Exchange, before the St. Louis, Missouri, Chamber of Commerce, April 12, 1946, in *The Commercial and Financial Chronicle*, April 18, 1946, pp. 2069, 2101; N. Y. Times, Dec. 17, 1946, § 2, p. 49, cols. 4, 5 (remarks by Senator Bridges of New Hampshire). Effective February 1, 1947, the Board reduced margin requirements to 75%. See N. Y. Times, Jan. 18, 1947, § 1, p. 1, cols. 2, 3.

11. See Comment (1946) 56 YALE L. J. 333.

met will suggest that further reforms should be directed at other problems.¹² The first section describes the more common types of manipulation that were employed prior to 1934; the remaining sections discuss the common law doctrine with regard to market manipulation, the controls provided by the Securities Exchange Act of 1934, and the impact of the statutory controls on organized exchanges and the over-the-counter market.

METHODS OF MANIPULATION

Market manipulation¹³ refers to widely varying types of devices used to stimulate or to discourage the buying and selling of securities. The ready transferability of stocks and bonds makes the securities markets highly susceptible to such activities.

Information, true or false, complete or incomplete, is the basis for the individual judgments which lead investors or speculators to buy, sell or hold securities. Consequently publicity has been one of the most commonly employed manipulative techniques. One of the earliest forms was the spreading of false rumors about political or economic affairs,¹⁴ or the affairs of a single security issuer,¹⁵ leading the public to form erroneous judgments and take market action. Word of mouth rumor-mongering was augmented by the use of fake financial services, tip sheets, bribed financial writers,¹⁶ and bribed customers' men or brokers who, without disclosing their financial interests, would recommend certain securities. Successful manipulation by publicity techniques was not limited to rumors which were false. If a manipulation by other means than publicity were planned, its success could be promoted by the spreading of advance notice among persons anxious to get in on the ground floor.¹⁷

In a highly liquid securities market, however, the most successful form of publicity may be the appearance of the market itself, the published record of the volume of trading and prices. The simplest way to assure a desired market appearance, aside from outright falsification of the records, is for

12. Previous investigations into the subject of speculation have, to a large extent, centered on the problem of manipulation. See *Report of Governor Hughes' Committee on Speculation in Securities and Commodities, June 7, 1909; Hearings before a Subcommittee of the Committee on Banking and Currency on House Resolutions 429 and 504, 62nd Cong., 2d Sess. (1912) (Pujo "Money Trust" Investigation); Hearings before Committee on Banking and Currency on S. 3895, 63d Cong., 2d Sess. (1914); Senate investigation, supra note 4.*

13. For more complete descriptions of the details of manipulative devices than that here attempted see Mathias, *Manipulative Practices and the Securities Exchange Act (1936)* 3 U. OF PITTS. L. REV. 7, 104; Moore and Wiseman, *Market Manipulation and the Exchange Act (1934)* 2 U. OF CHI. L. REV. 46; Comment, *Market Manipulation and the Securities Exchange Act (1937)* 46 YALE L. J. 624.

14. See *Rex v. De Berenger*, 3 M. & S. 67, 105 Eng. Rep. R. 536 (K. B. 1814) (spreading of false rumors about Napoleon's death). See note 42 *infra* for the background on this case.

15. See *People v. Goslin*, 67 App. Div. 16, 73 N. Y. S. 520 (1st Dep't 1901).

16. See *Ridgely v. Keene*, 134 App. Div. 647, 119 N. Y. S. 451 (2d Dep't 1909).

17. TWENTIETH CENTURY FUND, INC., *THE SECURITY MARKETS* (1935) 478.

the manipulators to enter both buy and sell orders for the same security at the same price, thus producing a recorded transaction in the market indistinguishable by external appearances from a normal transaction executed by independent buyers and sellers. Where one party is at both ends of the transaction, it is called a wash sale. If confederates cross-trade between themselves, it is known as the matched order. The wash sale and matched order have been largely phenomena of organized exchanges because the availability of brokerage services for the entry and quick execution of the orders, and the widespread dissemination by ticker and newspaper services of the reports of transactions, increase the effectiveness of the technique.¹⁸

Wash sales and matched orders are methods of insuring that an appearance of market activity or a price is created or maintained. Such insurance may be unnecessary, however. For instance, the mere placing of a bid for a security in the market conveys to observers the impression that there is interest in that security; the contrary impression will be created by the placing of an offer to sell. If, then, a member of the public decides to buy or sell and enters an order which meets the standing bid or offer, an executed transaction results which will contribute as much to the appearance of the market as a wash sale or a matched order. If one person or a group engages in a sustained amount of buying or selling in a given security, the result will be an appearance of active trading and a price, the level of which will depend upon the number of shares of the security in the hands of holders responsive to market appearances or ready to engage in trading for any reason. These results obtain, whatever is the purpose of the buying or selling by the individual or group. It may be to acquire, liquidate or shift an investment. It may be a speculative move, because of the belief that the market price will change due to factors other than the immediate effect of the speculative buying or selling by the individual or group. If, however, it is to produce or maintain a market appearance of trading activity or a price change by the effect of the immediate buying or selling, it may be described as manipulation by actual purchases and sales, whatever the further purpose of the manipulation is.¹⁹

The primary use of manipulation by actual purchases and sales is to produce an increased market price. It may be that a block of stock is to be distributed, and the distributors desire to obtain a better price for the stock than the existing market price. If the distributors go into the market and

18. The effectiveness of wash sales and matched orders depends on public reporting of them. See Berle, *Liability for Stock Market Manipulation* (1931) 31 COL. L. REV. 264, 270-1.

19. This species of manipulation is not always so broadly defined. It is frequently said that only "bad" manipulation, meaning bull or bear raiding or comparable activity to change the market price is really manipulation. See Daley, *Secondary Market Death Sentence* (June 10, 1938) 8 INVESTMENT BANKING 194. It seems of greater analytical value, however, to class together all buying and selling which has as its immediate purpose an effect on the appearance of the market, saving the distinctions for the more remote ends involved. Compare TWENTIETH CENTURY FUND INC., *THE SECURITY MARKETS* (1935) 444.

buy up those amounts of the security currently being offered, an increased market price may result. The effectiveness will depend upon how much of the stock is brought onto the market by holders ready to sell at a small increase in price. The numbers of these potential sellers may be reduced temporarily by withholding agreements exacted from the holders of large blocks and by the use of other types of stimulation, such as publicity, to induce other persons to buy more rather than to sell what they have. When the total effect of this activity has produced the desired increase in market price, the distribution will begin.²⁰

The second most important use of manipulation by actual purchases and sales is to peg or stabilize the market price. When the distribution begins, whether the distribution price has been raised by manipulation or not, it will be in the interest of the distributors to maintain that price on the market throughout the course of the distribution. The market price may be subject to depression from a number of causes. Speculators or investors who have changed their minds may dump on the market the stocks which they bought in the direct distribution. Market conditions as a whole may become unfavorable. Buyers who would normally absorb sales in the open market may transfer their interest to the shares being distributed. If the distribution itself is taking place on the open market, perhaps on an organized exchange, these effects will be augmented by the weight of the selling pressure of the distribution itself. To counteract these effects the distributors support the market price by entering bids and by purchasing in the over-the-counter market or on the exchange to absorb whatever selling pressure is encountered.²¹

The converse of purchasing to raise the market price is selling to depress it. A well-timed number of sell orders, if sufficient in volume to overcome buying pressure, may succeed in driving the market price of a security down to a point at which it can be bought back at a profit. If the original sales were of securities actually owned by the seller, the total profit will depend upon the price at which they were originally purchased. It is possible, however, to sell securities not currently owned, through the medium of the short sale. The short sale may take two forms. It may be a sale for future delivery, or it may be a sale for present delivery, the seller borrowing stocks from some other holder in order to make the delivery. The seller must later purchase other shares in order to repay his lender. The latter form is predominantly used in this country. If sales made to drive down the market price are short sales, the total profit will be the difference between the selling price and the price of the covering purchase. The fact that the volume of

20. More complete expositions of the use of this technique by pools, syndicates, joint accounts and individuals may be found in SEN. REP. NO. 1455, 73d Cong., 2d Sess. (1934) 36-48; Comment (1937) 46 YALE L. J. 624; TWENTIETH CENTURY FUND, INC., *THE SECURITY MARKETS* (1935) 456-99.

21. The best brief discussion of stabilization is in Securities Exchange Act Release No 2446, Mar. 18, 1940.

selling which may be created is limited only by the amount of stock available for lending and not by the personal holdings of the manipulator makes the short sale more advantageous than the long sale in a manipulation to depress the market price.²²

An activity, allied to stabilization, which involves manipulation by actual purchases and sales, is that of market "sponsorship." There are two general situations in which sponsorship is practiced. At the close of the period of distribution of a security, when it is relatively unseasoned and undigested by the market, the price may be subject to great instability due to the resale of large amounts of the security by speculators and a relatively light demand to absorb the pressure because of the unknown qualities of the issue. At that point the principal underwriter who participated in the distribution may wish to make a market by purchasing insofar as necessary to maintain or stabilize the market price, reselling from his inventory as the opportunity appears. Market sponsorship, in a broader sense, is generally practiced, particularly in the over-the-counter markets, with respect to the lesser-known securities in which the volume of trading by non-professionals is too light to furnish any kind of a continuous market. For each of such securities there may be one or more dealers who are ready either to buy or sell at any time, thus furnishing a continuous market for the security. Such a dealer, who makes a market in a particular security, may exercise great control over the volume of trading and the market price by varying the ratio of his buying volume to his selling volume. If he conceives it desirable in his own interest or in the interest of the issuer or others, he may be able to maintain the market price of the security or to raise it or depress it.²³

Another activity of the same order is that of supporting the market against sudden breaks and panics. If this is done by a single dealer in a sponsored security, it may be no more than a further extension of the sponsorship device. If, however, the panic is such as to engulf the whole market, supporting activity may extend farther than sponsored stocks. In such a case, on an organized exchange, the officials may encourage the pooling of capital for the purpose of bidding in any or all securities to check or slow the declining prices. Perhaps the most notable example of this activity was the banker's pool in 1929.²⁴ A more recent example was the support buying done by members of the New York Stock Exchange in utility stocks when a large volume of selling broke out following the decision of the Supreme Court in *Ashwander v. T. V. A.* upholding the constitutionality of the T. V. A.²⁵

From this brief summary of the general types of manipulation it can be seen that two chief problems present themselves. First, as to each type of

22. See SEN. REP. NO. 1455, 73d Cong., 3d Sess. (1934) 50-3; WHITNEY AND PERKINS, *SHORT SELLING FOR AND AGAINST* (1932) 156.

23. TWENTIETH CENTURY FUND, INC., *THE SECURITY MARKETS* (1935) 267.

24. *Id.* at 459.

25. SEC, *REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER* (1936) 24.

manipulation, there must be a judgment made as to its effects on individual persons and on the operation of the market. Little difficulty is encountered here in condemning outright such devices as false publicity, bribes, wash sales and matched orders. As will be developed more fully, however, the evaluation of manipulation by purchases and sales is not so easy. Second, effective techniques of prevention or regulation must be developed. Here again, the problem is greatest with respect to manipulation by purchases and sales.

CONTROLS BEFORE 1934

In the analysis of controls of manipulative activity which developed prior to the Securities Exchange Act of 1934 two phases should be distinguished: first, the growth of a legal doctrine that only partially matched the range of activities involved; and second, the growth of enforcement techniques which proved completely inadequate.

The legal approach to the problem of market manipulation was primarily through the concept of fraud. This was, perhaps, inevitable since the beginnings were made in times when public participation in security trading was negligible.²⁶ Legal remedies were usually called into play only when invoked by an individual who thought he had been cheated, or when the manipulators fell out and went to court to settle their differences. Wash sales and matched orders early came to be regarded as "fictitious" transactions, used to misrepresent the actual state of the market.²⁷ Organized exchanges forbade their members to use them.²⁸ Eventually, they formed a basis for criminal indictments for conspiracy to defraud.²⁹ False rumors designed to unsettle security prices have long been condemned, largely because of their use to defraud.³⁰ The touting of stocks through fake financial services, bribed financial writers, and the bribing of brokers and customers' men³¹ likewise were classed as fraudulent practices. Courts might refuse to enforce contracts based on such services, and injunctions were used against their enforcement.³²

The reach of strict fraud doctrine was, however, far too short. The damage to a person who bought a worthless stock in reliance on the apparent activity created by wash sales might be regarded as too remote a consequence of the manipulative activity, or the wash sale might not be regarded as a repre-

26. 1 MYERS, *THE NEW YORK MONEY MARKET* (1931) 296.

27. *Report of Governor Hughes' Committee on Speculation in Securities and Commodities*, June 7, 1909, p. 7.

28. WARSHOW, *UNDERSTANDING THE NEW STOCK MARKET* (1934) 5.

29. *United States v. Brown*, 5 F. Supp. 81 (S. D. N. Y. 1933), *aff'd*, 79 F. (2d) 321 (C. C. A. 2d, 1935).

30. *Rex v. De Berenger*, 3 M. & S. 67, 105 Eng. Rep. R. 536 (K. B. 1814).

31. *United States v. Brown*, 5 F. Supp. 81 (S. D. N. Y. 1933).

32. *Ridgely v. Keene*, 134 App. Div. 647, 119 N. Y. S. 451 (2d Dep't 1909); *Stevens v. Wallace*, 106 N. J. Eq. 352, 150 Atl. 835 (1930).

sensation on which anyone had a right to rely.³³ The fraud concept largely failed to reach manipulation by actual purchases and sales. The single strong expression of legal opinion against it was in the English case of *Scott v. Brown*.³⁴ There the court on the ground of public policy refused to aid a party to a contract having as its object the purchase on the market of the shares of a new corporation in order to raise the market price and induce the public to subscribe. By way of dictum, the court declared that this would be ground for a civil action for damages and a criminal indictment for conspiracy to defraud. Yet a few years later the same court was willing to enforce a contract by which a jobber on the London Stock Exchange made a market in a stock in order to control its price while a pool was engaged in distributing a block of it.³⁵ In the United States prior to 1934 no case established the illegality of any form of manipulation by actual purchases and sales, although *United States v. Brown*³⁶ has been widely cited as establishing such a rule.³⁷

The inadequacies of common law fraud doctrine were bolstered to some extent by statutory expressions of a broader concept of fraud. New York passed laws against wash sales, matched orders and the use of rumors designed to unsettle security prices.³⁸ The mail fraud statute was brought into use in appropriate cases.³⁹ Here again, however, the scope was too limited to reach manipulation by actual purchases and sales.

Although the fraud concept was the chief reliance in the early law of manipulation, the development of an alternative approach based on the public

33. *McGlynn v. Seymour*, 14 Daly 420 (N. Y. 1888).

34. 2 Q. B. D. (1892) 724.

35. *Sanderson & Levi v. British Westralian Mines & Shares Corp. Ltd.*, 43 SOL. J. 45 (K. B. 1898).

36. 5 F. Supp. 81 (S. D. N. Y. 1933).

37. See Berle, *Stock Market Manipulation* (1938) 38 COL. L. REV. 393, 397. The author, relying largely on *United States v. Brown* and *Harris v. United States*, 48 F. (2d) 771 (C. C. A. 9th, 1931), states ". . . Wash sales, matched orders, artificial activity, pegging operations, and mere false representations to the market, all constituted fraud and deceit, which would presumably give rise to a civil action . . . injunction under an appropriate statute, or to criminal action under appropriate state or federal laws." However, the limited grounds upon which the appellate court affirmed the trial court in *United States v. Brown* hardly justify such a broad statement as to "artificial activity" and "pegging operations," despite the trial judge's extensive review and professed approval of the supposed English rule. See *United States v. Brown*, 79 F. (2d) 321 (C. C. A. 2d, 1935). *Harris v. United States* likewise rested primarily on practices such as wash sales, falsified trading reports and direct misrepresentations to purchasers. The only other two common law American cases to bring directly in issue manipulation by actual purchases and sales, *Harper v. Crenshaw*, 82 F. (2d) 845 (App. D. C. 1936), and *Bigelow v. Oglesby*, 302 Ill. App. 27, 23 N. E. (2d) 378 (1939) were decided after 1934 on grounds of public policy, and, although the Act did not apply, the public policy as there expressed must have had weight in the decisions.

38. The Martin Act, New York General Business Law, Art. 23-A. See *People v. Rice*, 221 App. Div. 443, 223 N. Y. S. 566 (1st Dep't 1927).

39. *United States v. Brown*, 5 F. Supp. 81 (S. D. N. Y. 1933); *Harris v. United States*, 48 F. (2d) 771 (C. C. A. 9th, 1931).

interest in a free market could be detected. For instance, a market in which there are no sellers is not a free market, and the deliberate creation of such a situation by cornering all the available supply of a stock has been held to be in restraint of trade.⁴⁰ Contracts having such a corner as their object would not be enforced by the courts,⁴¹ and exchange authorities in such a situation might suspend normal trading and order the settlement of outstanding contracts at a fixed price in order to break the jam. Yet combinations to achieve less than the complete domination of the market implicit in a corner were singularly free from restraint.⁴²

Overshadowing the shortcomings of the legal doctrine developed to meet market manipulation was the failure of the legal remedies to measure up to the job of actual control. Crises in the securities markets were frequently followed by investigations to determine the causes. The Pujo committee, Governor Hughes' committee, and the Senate Banking and Currency committee,⁴³ each at different periods of time, found that manipulation had not been effectively outlawed. Although wash sales and matched orders were regarded as fraudulent, examples of civil liability based on them were almost non-existent. Even in England, where manipulation by actual purchases and sales was said to be banned, the court in *Scott v. Brown* admitted it was every-day practice,⁴⁴ and in neither country could a case of criminal or civil liability be found based on the practice.

CONTROL UNDER THE SECURITIES EXCHANGE ACT THE STATUTE

The law of market manipulation under the Act may be contrasted with the common law both in terms of legal doctrine and the machinery of en-

40. *United States v. Patten*, 226 U. S. 525 (1913); but see *Albers Comm. Co. v. Spencer*, 205 Mo. 105, 103 S. W. 523 (1907). Compare BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) 295-6.

41. *Sampson v. Shaw*, 101 Mass. 145 (1869). But see *Barry v. Croskey* 2 J. & H. 1, 70 Eng. Rep. R. 945 (Chancery 1861); *Salaman v. Warner* (and others), 64 L. T. R. (N. S.) 598 (Q. B. 1891), *aff'd*, 65 L. T. R. (N. S.) 132 (C. A. 1891).

42. The early English statutory crimes of regrating (buying goods in market and reselling them in or near the same market), forestalling (buying up goods before they reach the market and spreading false rumors about the market), and engrossing (cornering the supply) furnish interesting analogies to the common law of market manipulation, and it is possible to trace their influence into such decisions as *Rex v. De Berenger*, 3 M. & S. 67, 105 Eng. Rep. R. 536 (K. B. 1814) (false rumors) and those involving corners. But the analogies are weakened by the fact that these crimes were statutory attempts to protect the royal grant of monopoly privileges and were repealed before the nineteenth century. See Mason, *Monopoly in Law and Economics* (1937) 47 YALE L. J. 34, 38-9 ("... it seems doubtful whether the ancient law respecting engrossing, forestalling and regrating has made much of a contribution to present legal concepts of monopoly . . ."); HANDLER, *CASES AND OTHER MATERIALS ON TRADE REGULATION* (1937) 28-33; OPPENHEIM, *CASES ON TRADE REGULATION* (1936) 10-1.

43. See note 12, *supra*.

44. *Scott v. Brown*, 2 Q. B. D. 724, 729 (1892).

forcement. Although it has been stated that the primary contribution of the Act was in its development of an adequate enforcement agency to police the markets, and that the law to be enforced was merely codified,⁴⁵ it is more accurate to say that there was a definite progression from the earlier law in both respects.

Legal doctrine. The Act accelerated the expansion of the concept of fraud to take within its scope all the various techniques of manipulation. This is most clearly exemplified by the rule, now well established, that the failure to disclose that the price at which a security is bought or sold is affected by manipulative activity of any kind is a misrepresentation by omitting to state a material fact.⁴⁶ This doctrine is not explicitly stated in the Act. It is rather an interpretation of those sections, which forbid or regulate manipulation, to mean that such activity is a material fact. Being a material fact, it must be disclosed under the Securities Act of 1933.⁴⁷

Some of the specific provisions dealing with manipulation in themselves display their origin in the law of fraud. Section 9, which applies to exchange trading, declares unlawful wash sales and matched orders if effected "for the purpose of creating a false or misleading appearance of active trading in any security . . . or a false or misleading appearance with respect to the market for any such security. . . ." ⁴⁸ This phraseology treats the wash sale and matched order as a form of misrepresentation; it is an expanded concept of fraud, however, since there need be no showing of damage to anyone. Section 9(a)(2) 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." This provision is aimed directly at manipulation by actual purchases and sales. With respect to those cases in which actual purchases and sales are used in the same manner that wash sales and matched orders are used—to misrepresent the state of the market—Section 9(a)(2) is only a logical progression from the common law; it is still within an expanded fraud theory. Whether the scope of the section is actually so limited will be discussed below.

45. Berle, *supra*, note 37, at 399.

46. *S. E. C. v. Otis & Co.*, 106 F. (2d) 570 (C. C. A. 6th, 1939); *In the Matter of Russell Maguire & Co., Inc.*, 10 S. E. C. 332 (1941). The same principle is enforced by the Commission by forcing disclosure in registration statements under the Securities Act of 1933 of securities to be offered "at the market" when the market has been or is being affected by "artificial" influences. *Richard Ramore Gold Mines, Ltd.*, 2 S. E. C. 377 (1937); *Canusa Gold Mines, Ltd.*, 2 S. E. C. 548 (1937); *Old Diamond Gold Mines, Ltd.*, 2 S. E. C. 786 (1937); *Potrero Sugar Co.*, 5 S. E. C. 982 (1939); *Reiter Foster Oil Corp.*, 6 S. E. C. 1028, 1048-51 (1940).

47. 48 STAT. 74 (1933), 15 U. S. C. § 77a (1940), the substance of which has been incorporated by regulation in the 1934 Act. See Rules X-10B-5 and X-15C1-2, Rules and Regulations under the Securities Exchange Act. (Hereafter all rules and regulations under the 1934 Act will be cited by number only.)

48. Section 9(a)(1).

Section 9(a)(4) forbids "false or misleading" statements with regard to material facts in inducing the purchase or sale of a registered security—clearly an embodiment of the fraud concept. Section 10(b) forbids the use in connection with the purchase or sale of registered or unregistered securities of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. Section 15(c)(1) forbids brokers or dealers to effect a transaction in or to induce the purchase or sale of a security over the counter by means of "any manipulative, deceptive or other fraudulent device or contrivance," as defined by the Commission. Thus, Section 10(b) applies to all securities, whether traded in an organized exchange or over the counter by any person; Section 15(c)(1) applies only to transactions over the counter by brokers and dealers. The detailed specification of illegal activities by Commission definitions under these two sections has been primarily directed to erecting a fraud standard of conduct. For instance, it has been made illegal to stimulate exchange trading in a security, which is currently being distributed, by bribing brokers or customers' men to solicit purchases on the exchange;⁴⁹ this rule is to meet one device for using the market itself as an indirect representation of value to prospective purchasers in the distribution.

A view of the Act as designed to protect public interests beyond the suppression of fraud contributed to shaping its anti-manipulative provisions. Section 9(a)(2), which includes a fraud standard, at least as a minimum, has broader implications. By contrast with the wash sale and matched order section, which proscribes those devices only if intended to mislead, manipulation by actual purchases and sales is banned if intended to induce others to buy or sell the security. The Commission has found that this makes room for condemning activities which fall short of "actual fraud."⁵⁰

Sections 9(a)(3) and (5) forbid the use of tips of impending manipulated price changes to induce purchases or sales of securities. The policy of insulating the public from incentives to excessive speculation⁵¹ is the primary aim here, rather than protection of purchasers and sellers from fraud. Section 9(a)(6) subjects to Commission regulation manipulation by actual purchases and sales for the purpose of "pegging, fixing, or stabilizing" the price of registered securities. As will be discussed below, this must be regarded as an exception to the blanket condemnation of Section 9(a)(2), an exception based on the supposed public interest in the stabilization device

49. Rule X-10B-2.

50. In the Matter of White & Weld, 3 S. E. C. 466, 513 (1938). See Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934* (1934) 21 VA. L. R. 139, 156.

51. The theory that the public must be protected against its own reckless proclivities has been a recurring one in the securities market literature. The Hughes Committee felt that "a real distinction exists" between speculation by "persons of means and experience" and that by the uninformed general public. *Report of Governor Hughes' Committee on Speculation in Securities and Commodities, June 7, 1909*, p. 4. In his message to Congress recommending securities exchange legislation President Roosevelt echoed the theme. SEN. REP. No. 792, 73d Cong., 2d Sess. (1934). See also SIMPSON, *THE MARGIN TRADER* (1938) 132-4.

in aid of security distributions. Short selling, while within the scope of Section 9(a)(2) governing manipulation by actual purchases and sales, was made subject to Commission regulation by a separate section.⁵² Behind the anti-manipulative provisions as a whole was the conviction that manipulation bred excessive speculation and unstable security prices which, irrespective of fraud, injured the public by unsettling the credit cycle and interfering with the proper performance of the market function in valuing securities.⁵³ Thus, there have been a variety of policy considerations which have led to broader treatment than would have been attempted within the more limited confines of the fraud theory.

Enforcement machinery. The Act bridged the gap between legal theory and actual practice by providing the Commission with broad powers of investigation in order to detect manipulation and a wide variety of remedies with which to proceed. In the utilization of these powers, the professed purpose of the Commission has been to detect manipulation at its inception and prevent it, rather than to apply the statutory remedies after the damage has been done. Necessarily, therefore, much of the enforcement activity consists of informal investigations, personal consultations, and the answering of detailed questions propounded to the Commission concerning its interpretation of the law.⁵⁴ The base upon which all of the enforcement activity rests is the system of market watching which the Commission maintains. The data on trading in large numbers of securities are studied for unexplained variations, which may then be investigated.⁵⁵

If remedial action becomes necessary, a wide choice of remedies is offered. The administrative remedies have been the most important. Where members of organized securities exchanges are involved, proceedings to suspend or expel them from membership may be instituted.⁵⁶ In the case of brokers or dealers doing business in interstate commerce, their registrations with the Commission may be revoked.⁵⁷ Finally, proceedings to suspend or expel members of the National Association of Security Dealers may be used against brokers or dealers holding membership in that organization.⁵⁸ Each of these is a penalty of great severity. Damage to reputation is perhaps the most serious consequence. Loss of stock exchange membership is the loss of trading advantages as broker, dealer, or personal trader.

There have been only two expulsions from national exchanges for manipulative activity;⁵⁹ the lighter penalty of suspension has been inflicted in four

52. Section 10 of the Act; see SEN. REP. No. 1455, 73d Cong., 2d Sess. (1934) 50-5.

53. See § 2 of the Act.

54. Purcell, *The Structure and Functions of the Securities and Exchange Commission* (1945) 6 FED. BAR. ASS'N J. 241, 252.

55. S. E. C. ANN. REP. (1944) 64-5.

56. Section 19(a)(3).

57. Section 15(b).

58. Section 15 A(l)(2).

59. In the Matter of Meehan, 2 S. E. C. 588 (1937); In the Matter of Wright, 3 S. E. C. 190 (1938).

cases.⁶⁰ The National Association of Security Dealers is the broker-dealer association organized and registered under the Maloney Act for the semi-private regulation of the over-the-counter securities market.⁶¹ Membership, estimated at about 90% of the country's brokers and dealers, confers an economic advantage in that members may grant each other price concessions which they may not grant non-members.⁶² Membership is not, however, a prerequisite to doing business. There have been no expulsions from the N.A.S.D. for manipulative activity; there have been three cases resulting in suspensions.⁶³ Broker-dealer registration with the Commission is a prerequisite to doing an interstate securities business.⁶⁴ Revocation of this license is, therefore, tantamount to a ban on doing business. Only one case of such revocation has occurred for manipulative activity,⁶⁵ although in one case voluntary withdrawal of registration was allowed where a violation was found.⁶⁶ In administering these remedies the Commission has exercised considerable latitude in adjusting the penalty to the seriousness of the offense. Thus, where it was found that the suspension of a Commission rule might have deceived the violator into a misconception of the state of the law, the lighter penalty of suspension from the N.A.S.D. was employed rather than expulsion.⁶⁷

Under Section 21(e) the Commission may bring an action in the federal courts for a temporary or permanent injunction "whenever it shall appear to the Commission that any person is engaged or is about to engage" in any prohibited activity. An early restrictive interpretation of this section required that the defendants be engaged in the illegal activity at the time the Commission filed the bill, or be about to engage in such activity at that time.⁶⁸ Since the institution of an investigation by the Commission is a

60. In the Matter of White & Weld, 3 S. E. C. 466 (1938); In the Matter of Richards, 4 S. E. C. 742 (1939); In the Matter of Merrill, 8 S. E. C. 620 (1941); In the Matter of Kidder Peabody & Co., Securities Exchange Act Release No. 3673, Apr. 13, 1945.

61. Comment (1939) 48 YALE L. J. 633.

62. See Rules of Fair Practice of National Association of Security Dealers, Inc., July 15, 1939, Section 25.

63. In the Matter of Barrett & Co., 9 S. E. C. 319 (1941); In the Matter of Masland, Fernon & Anderson, 9 S. E. C. 338 (1941); In the Matter of Kidder Peabody & Co., Securities Exchange Act Release No. 3673, Apr. 13, 1945.

64. Section 15(a).

65. In the Matter of M. S. Wien & Co., Securities Exchange Act Release No. 3855, Sept. 17, 1946.

66. In the Matter of Russell Maguire & Co., Inc., 10 S. E. C. 332 (1941).

67. In the Matter of Barrett & Co., 9 S. E. C. 319 (1941); In the Matter of Masland, Fernon & Anderson, 9 S. E. C. 338 (1941). Another administrative control available to the Commission, under authority given by Section 19(a)(4), is to suspend trading in a registered security for ten days if in the Commission's opinion the public interest so requires. It was under this section that trading was suspended in the common stock of Kresge Department Stores, Inc., when it made an unexplained rise from $1\frac{5}{8}$ to $7\frac{1}{2}$ at a time when the company was in dissolution and the maximum liquidating value of each share was two dollars. See N. Y. Times, Aug. 3, 1946, p. 19, cols. 6, 7.

68. S. E. C. v. Torr, 87 F. (2d) 446 (C. C. A. 2d, 1937).

necessary condition precedent to bringing such an action, thus effectively warning the manipulators to desist for a time, this interpretation threatened to rob the injunctive remedy of its value. A more liberal reading by another court, however, required only that the defendants be engaged or about to engage in the illegal activity at the institution of the Commission's investigation.⁶⁹ Nevertheless, the potentiality of other restrictive decisions has led the Commission to suggest that the section be amended to grant the right to an injunction whenever the manipulator "has engaged" in the prohibited acts.⁷⁰ There is only one published instance in which the Commission has won a temporary injunction under Section 21(e), and the injunction was dissolved on appeal.⁷¹

The most drastic weapon in the Commission's arsenal is criminal prosecution for wilful violations, a sanction which has been very rarely employed.⁷² Although criminal prosecutions are in form brought by the Attorney General, the evidence on which to base a prosecution is furnished by the Commission with its recommendation for prosecution.⁷³ In the case of illegal manipulations a common alternative to criminal action under the 1934 Act has been a criminal proceeding under the Securities Act of 1933, alleging the omission to state a material fact by concealing manipulative activity from security purchasers in violation of Section 17(a)(2) of that Act.⁷⁴

69. *Otis & Co. v. S. E. C.*, 106 F. (2d) 579 (C. C. A. 6th, 1939).

70. This suggestion was adopted as the recommendation of both the Commission and the security industry representatives in the joint conference which preceded the 1942 hearings on proposed amendments to the Securities Acts. See Report on the Conferences with the S. E. C. and its Staff on Proposals for Amending the Securities Act of 1933 and the Securities Exchange Act of 1934 by the Representatives of IBA, NASD, NYCE, and NYSE, July 30, 1941, at 285. This joint study of proposed amendments to the securities laws has recently been resumed. See *N. Y. Times*, Jan. 18, 1947, § 2, p. 19, cols. 6, 7.

71. Temporary injunction granted, *S. E. C. v. Torr*, 15 F. Supp. 315 (S. D. N. Y. 1936); dissolved on appeal, 87 F. (2d) 446 (C. C. A. 2d, 1937); permanent injunction entered (on showing that the manipulators "were engaged" in the illegal acts when the Commission filed the bill), 22 F. Supp. 602 (S. D. N. Y. 1938). Temporary injunctions were denied in *S. E. C. v. Andrews*, 1 S. E. C. Jud. Dec. 265 (S. D. N. Y. 1936); *S. E. C. v. Saphier*, 1 S. E. C. Jud. Dec. 291 (S. D. N. Y. 1936); cf. *S. E. C. v. Bennett*, 62 F. Supp. 609 (S. D. N. Y. 1945).

72. Section 32. Only one case of criminal prosecution under the 1934 Act for manipulation has been officially reported. *United States v. Minuse*, 114 F. (2d) 36 (C. C. A. 2d, 1940); same case, 142 F. (2d) 388 (C. C. A. 2d, 1944). There have been other cases, however, in the United States District Courts, the opinions of which were unreported. See Securities Exchange Act Release No. 2410, Feb. 15, 1940 (manipulators pleaded guilty in case of B. G. Sandwich Shops, Inc.).

73. Section 21(e).

74. Another theoretical means of enforcement is civil liability for manipulative activity based on Section 9(e), although to date the provisions have never been successfully invoked. The immense task of assembling the evidence necessary for proof of a manipulation case is beyond the competence of most private parties. A statutory basis for civil liability based on manipulation of unregistered securities [Section 9(e) is limited to registered securities] has been found in Section 29(b), as amended in 1938, but it has added nothing to the enforcement of the Act. See *Geismar v. Bond & Goodwin, Inc.*, 40 F. Supp. 876 (S. D. N. Y. 1941); compare *Rosenberg v. Hano*, 26 F. Supp. 160 (E. D. Pa. 1938).

THE ORGANIZED EXCHANGES

The statutory basis for the control of manipulation in exchange trading is Section 9. In the administration of this section the problems encountered with respect to Subsections (1), (3), (4), and (5) have been relatively minor. The prohibition of wash sales and matched orders in Subsection (1) is the most important of this group, and the chief difficulty encountered has been that of establishing the necessary element of illegal purpose.⁷⁵ Even before the Act, wash sales and matched orders were avoided by sophisticated manipulators in favor of more refined devices.⁷⁶ The more difficult questions have arisen with respect to the interpretation of the ban on manipulation by actual purchases and sales contained in Section 9(a)(2), the implied legalization of stabilization in Section 9(a)(6), and the regulation of short selling. The diversification of treatment accorded these three problems discloses that the job of the Commission here involves far more than the mere negative prevention of fraud. Within the scope of Section 9(a)(2) there has been a development of a body of doctrine for distinguishing patterns of illegal activity; stabilization has been sanctioned within limits as serving the public interest despite possibilities of abuse; and short selling has been seriously restricted irrespective of its manipulative aspects.

Interpretation of Section 9(a)(2).

"To effect, alone or with one or more other persons a series of transactions in any security registered on a national securities exchange." When a person initiates a buy or sell order which results in an executed transaction, he has "effected" a transaction in that security. If a number of persons initiate such transactions pursuant to a common plan, each would be said to have "effected" his transactions "with one or more other persons." Restricted to such scope, however, the reach of Section 9(a)(2) would be too short. Of necessity, the interpretation has been broad. For instance, it has been held that transactions effected by friends,⁷⁷ relatives,⁷⁸ business associates,⁷⁹ employees,⁸⁰ persons acting on tips and rumors traceable to the manipulators,⁸¹ persons acting upon the advice of persons bribed by the manipulators,⁸² as well as transactions initiated by the manipulators themselves in the name of

75. Wash sales and matched orders ". . . For the purpose of creating a false or misleading appearance of active trading . . . or a false or misleading appearance with respect to the market . . ." for a security are illegal. See *In the Matter of White & Weld*, 3 S. E. C. 466, 510 (1938).

76. *TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS* (1935) 471.

77. *In the Matter of Meehan*, 2 S. E. C. 588, 605 (1937).

78. *Ibid.*

79. *In the Matter of Merrill*, 8 S. E. C. 620 (1941).

80. *In the Matter of Russell Maguire & Co., Inc.*, 10 S. E. C. 332 (1941).

81. *In the Matter of Meehan*, 2 S. E. C. 588, 618 (1937).

82. *S. E. C. v. Torr*, 22 F. Supp. 602 (S. D. N. Y. 1938); *R. J. Koeppe & Co. v. S. E. C.*, 95 F. (2d) 550 (C. C. A. 7th, 1938).

discretionary accounts,⁸³ may be within the scope of the phrase. The chief problem under such a broad interpretation is a factual one. Is the purchasing done by persons acting on the advice of another broker who has recently talked to the manipulator properly attributable to the manipulator?⁸⁴

The term "series" has been interpreted to mean two or more transactions. Thus, where three actual purchases were all that were executed in the course of what was found to be a manipulation, they constituted a series of transactions.⁸⁵ In any manipulation of any consequence there is no difficulty in isolating more than one transaction in order to find a series. This is particularly true in view of the Commission's interpretation that "transactions" means unexecuted bids and offers as well as executed purchases and sales.⁸⁶ This is a ruling of necessity in view of the recognized price effect of unexecuted bids and offers in the market.

Only dealings in securities registered under the Act are directly within the scope of Section 9, but the effect of the Section is somewhat more extensive. Unregistered securities which are admitted to unlisted trading privileges on national exchanges are treated as registered securities and are therefore subject to Section 9.⁸⁷ In addition, the Commission has by rule extended the scope of Section 9 to any securities which are exempted from the registration provisions of the Act pursuant to an order which specifically declares them subject to this rule.⁸⁸ Furthermore, it is immaterial whether a manipulation in any of the above securities takes place on an exchange or over-the-counter; in either case Section 9 applies.⁸⁹

"*Creating actual or apparent active trading in such security.*" The determination whether a particular pattern of new trading has created actual or apparent active trading is a function of the prior state of the market in the security, the number of shares actively traded, and the general level of market activity as well as of the particular trading attributable to the alleged manipulator. Therefore, generalization as to how much trading is active trading is impossible. In the *Meehan* case, over a period of ten days, 15,400 out of a total of 40,900 purchases were attributed to Meehan directly, in addition to which considerable activity by specialists, stimulated by Meehan's trading, was considered as part of the active trading created.⁹⁰ In the *Wright* case 79% of the purchasing in the manipulated stock on one day of trading constituted the illegal activity.⁹¹ The trading which will be con-

83. In the Matter of Meehan, 2 S. E. C. 588 (1937); In the Matter of Wright, 3 S. E. C. 190 (1938).

84. See In the Matter of Meehan, 2 S. E. C. 588, 619-20 (1937).

85. In the Matter of Kidder Peabody & Co., Securities Exchange Act Release No. 3673, April 3, 1945.

86. *Ibid.*

87. Section 12(f).

88. Rule X-10B-1.

89. In the Matter of Wright, 3 S. E. C. 190, 213 (1938).

90. In the Matter of Meehan, 2 S. E. C. 588, 616 (1937).

91. In the Matter of Wright, 3 S. E. C. 190, 195 (1938).

sidered as created by a series of transactions is, first, the series of transactions itself and, second, whatever trading by outsiders may be considered as induced by or drawn in by the appearance of the market, as was the trading by specialists mentioned above in the *Meehan* case. In the *Kidder-Peabody* case the placing of a market bid for twenty-five bonds following a nine-day period in which the largest block traded consisted of three bonds was said to create an "impression of sudden active interest in the bonds."⁹² This was followed by evidence that an outside trader, influenced by the large bid, entered a purchase order for eleven bonds, believing that he would be unable to get them at a lower price due to the presence of a strong bidder in the market. His trading was considered to be created by the series of manipulative transactions.⁹³

It should be noted that in the statute, "creating actual or apparent active trading" as an element of liability is alternative to raising or depressing the price. Nevertheless, there have been no published cases since the passage of the Act in which both the creation of active trading and a price change have not been present.

"Or raising or depressing the price of such security." The amount of price change is immaterial. It is necessary only to show that the series of transactions effected by the manipulators contributed to the price change. An unguarded implication in an opinion of the General Counsel of the Commission that a "substantial" change in price only would be illegal was quickly negated when asserted as a defense to a manipulation charge.⁹⁴ Price changes of only fractions of a point have been sufficient to make a case.⁹⁵ Many of the manipulation cases since 1934 have involved low price stocks, in connection with which a very small point variation may be very large when expressed in percentage terms. In no published cases since the passage of the Act have there been manipulations to depress security prices.

"For the purpose of inducing the purchase or sale of such security by others." The main inquiry in all manipulation cases has been toward establishing the purpose for which the more easily proved trading activity was undertaken. The problem may be divided into two parts. First, there may be established an intent to induce others to purchase a security in some way. This is frequently undisputed, and independent proof is usually not difficult. Second, it must be shown that the trading activity engaged in by the alleged manipulator was intended to assist in inducing purchasers to buy from him. Thus, where a dealer in railroad bonds executed a series of market purchases which raised the market price of an issue, some of which he was concurrently selling to other dealers on a wholesale basis, there was ample proof of the trading

92. In the Matter of Kidder Peabody & Co., Securities Exchange Act Release No. 3673, April 3, 1945, p. 12.

93. *Id.* at 13.

94. In the Matter of Russell Maguire & Co., Inc., 10 S. E. C. 332, 347 n. 22 (1941).

95. In the Matter of Kidder Peabody & Co., Securities Exchange Act Release No. 3673, April 3, 1945. (49¾ to 50¼).

activity and of an intent to induce the purchase of bonds by others, but the Commission concluded that there was insufficient proof of a purposive relation between the two.⁹⁶ Where an underwriter, who was to market a forthcoming issue of stock at a price related to the market price of stock of the same class outstanding, in a period of one hour purchased 3,800 shares of the outstanding stock on the exchange and raised the market price, a preliminary injunction was denied because the court was not convinced that the purchasing was for the purpose of promoting the later distribution.⁹⁷

Purpose must always be inferred. The manner in which the market trading is conducted may furnish the inference. Such things as frequently executing the opening and closing transactions of the day, "reaching" for the stock, and the entry of unduly large orders may disclose the intent to affect the market in a manner which is only consistent with a purpose to induce purchasing by others.⁹⁸ Usually, however, there must be resort to supplementary facts constituting the setting in which the manipulation is carried on. The fact that the parties have an option on a block of stock which will only prove profitable if the market price is induced to rise,⁹⁹ the ownership of a block of stock purchased at a price which may only be recouped in a rising market,¹⁰⁰ the use of other types of stimulation, such as publicity,¹⁰¹ payments to brokers or customers' men for touting,¹⁰² efforts to induce the issuer to put out favorable news or to declare a dividend,¹⁰³ efforts to disguise the origin of buying pressure by the use of dummy or discretionary accounts¹⁰⁴ are a few of the facts from which the inference has been drawn that the purpose was to induce purchasing by others.

Stabilization. No aspect of the control of manipulation under the Act has furnished more theoretical and practical difficulties than drawing the line between illegal manipulation under Section 9(a)(2) and permissible stabilization under Section 9(a)(6). Stabilization during a distribution is generally indistinguishable from any other kind of manipulation by purchases and sales as far as the statutory elements of illegality are concerned. If Section 9(a)(6) had not been included in the Act, stabilization would have been outlawed.¹⁰⁵

96. In the Matter of Strasburger & Co., Securities Exchange Act Release No. 3494, Oct. 16, 1943.

97. S. E. C. v. Bennett, 62 F. Supp. 609 (S. D. N. Y. 1945).

98. R. J. Koeppe & Co. v. S. E. C., 95 F. (2d) 550 (C. C. A. 7th, 1938); In the Matter of Wright, 3 S. E. C. 190, 198 (1938).

99. In the Matter of Meehan, 2 S. E. C. 588 (1937); In the Matter of Wright, 3 S. E. C. 190 (1938); United States v. Minuse, 114 F. (2d) 36 (C. C. A. 2d, 1940).

100. In the Matter of Russell Maguire & Co., Inc., 10 S. E. C. 332 (1941).

101. United States v. Minuse, 114 F. (2d) 36 (C. C. A. 2d, 1940).

102. S. E. C. v. Torr, 22 F. Supp. 602 (S. D. N. Y. 1938); R. J. Koeppe & Co. v. S. E. C., 95 F. (2d) 550 (C. C. A. 7th, 1938).

103. In the Matter of Russell Maguire & Co., Inc., 10 S. E. C. 332, 343, n. 18 (1941).

104. In the Matter of Meehan, 2 S. E. C. 588 (1937); In the Matter of Wright, 3 S. E. C. 190 (1938).

105. Since stabilization is used in aid of the distribution of securities it seems that there

Until 1938 the Commission adopted no rules regulating the practice of stabilization. Delimitation of its scope was accomplished by decisions under Section 9(a)(2), in which the defense was raised that the alleged manipulation was really stabilization,¹⁰⁶ and by published opinions of the General Counsel of the Commission.¹⁰⁷ Then the Commission came forward with a statement of policy on the subject of stabilization, recognizing that it is a form of manipulation, evaluating the conflicting considerations involved, and concluding that the public interest in the maintenance of the flow of capital to industry required the continuation of fixed price underwriting contracts and stabilization.¹⁰⁸ A broad program of regulation was announced, beginning with the limited and somewhat different problem of stabilization of securities issued "at the market."¹⁰⁹ Further regulations covering fixed price distributions have not been forthcoming, however.

The difficulty in generalizing about the validity of stabilization activities is attested to by the fact that opinions of the Commission's General Counsel on the subject are always couched in terms of specific fact situations, not in general terms. Nevertheless, certain propositions seem fairly well established. First, before, during and after a primary or secondary distribution it is permissible to enter the market with bids, purchases or sales in order to stabilize the market price provided that the amount of such trading is not greater than that necessary to peg the price,¹¹⁰ the price does not rise due to the stabilization trading,¹¹¹ and all persons to whom the stabilizers sell securities in the distribution are informed of the stabilization.¹¹² Second, the price which is stabilized must have been an independently established one.

is implicit in the concept, beyond the immediate purpose of "pegging, fixing, or stabilizing the price," as it is described in Section 9(a)(b), the further purpose of "inducing the purchase or sale of such security by others," as it is described in Section 9(a)(2). See Securities Exchange Act Release No. 3505, Nov. 16, 1943. The substance of many of the attacks on Section 9 and its administration has been that the line has (1) been so vaguely drawn as to curtail legitimate activities because of feared illegality, and (2) been so tightly drawn as to include too much within the ban of Section 9(a)(2). For specific formulation of these criticisms see *Wall Street Journal*, March 14-17, 1939 [amendment to section 9(a)(2) proposed by representatives of national security exchanges; reply by then-chairman of the Commission William O. Douglas]; *Hearings before the Committee on Interstate and Foreign Commerce on H. R. 4344, H. R. 5065, and H. R. 5832, 77th Cong., 1st Sess. (1941)* 69, 1359, 1407, 1409-12, 1444-56 [Amendments to Sections 9(a)(2) and 9(a)(b) in the Wadsworth bill, H. R. 4344].

106. This defense has been used in virtually all Section 9(a)(2) cases. See Securities Exchange Act Release No. 2446, March 18, 1940, p. 20.

107. See the following Securities Exchange Act Releases: No. 605, April 17, 1936; No. 3056, Oct. 27, 1941; No. 3505, Nov. 16, 1943; No. 3506, Nov. 16, 1943.

108. Securities Exchange Act Release No. 2446, March 18, 1940.

109. Securities Exchange Act Release No. 2363, Jan. 3, 1940.

110. Securities Exchange Act Release No. 3505, Nov. 16, 1943.

111. Securities Exchange Act Release No. 3506, Nov. 16, 1943.

112. The prospectus must contain notification that stabilization is contemplated. Securities Exchange Act Release No. 1890, Feb. 9, 1939. Where stabilization takes place in an exchange, notice is generally put on the ticker when stabilization commences and ceases.

If at the commencement of stabilization the market price still reflects the effect of a prior manipulation, the stabilizing transactions will also be illegal manipulation.¹¹³ Third, during the course of the distribution any trading in the market done by any members of the distribution group will be considered as part of the stabilization and must not be excessive in amount for that purpose and must not raise the price.¹¹⁴

Short Selling. Allegations of widespread manipulations to depress exchange prices through the medium of short selling in the period after the 1929 crash were the proximate cause of the initial post-1929 investigations of the exchanges.¹¹⁵ The emphasis, however, was less on short selling as a manipulative device than it was on its ethical implications and economic effects.

Any individual short sale has the same economic effect as a long sale. There will, of course, be the added later effect of the covering purchase. The total effect of short selling depends upon the volume and timing of the sales and covering purchases. The volume of short sales is expansible due to the fact that stocks available for lending may be borrowed more than once over a period of time. Critics of short selling point to this expansible feature of short selling as one danger inherent in the device. The timing of short sales and covering purchases is the basis, however, for the sharpest divergence between the proponents and opponents of short selling. Proponents say it is a source of stability for the market in that short selling while the market is rising serves to dampen the rise, and that subsequent covering purchases serve to check the ensuing decline, if there is one.¹¹⁶ Opponents say that short selling predominantly increases after the market has commenced falling and thus intensifies the drop, and that covering purchases either do not come in time to help check the fall or else their cushioning effect does not remedy the damage already done by the short selling.¹¹⁷ As is to be expected, the evidence for each point of view is incomplete and frequently conflicting.¹¹⁸

113. In the Matter of Meehan, 2 S. E. C. 588 (1937); In the Matter of White & Weld, 3 S. E. C. 466 (1938).

114. Securities Exchange Act Release No. 3505, Nov. 16, 1943. Certain more technical rules apply to stabilization also. If the issue is registered under the Securities Act of 1933, daily reports of stabilization trading must be sent to the Commission. Rule X-17A-2. If the offering is registered under the 1934 Act and priced "at the market," notice of intention to stabilize must be sent to the Commission and to the exchange on which the security is principally traded, and the price at which stabilization purchases may be made is so regulated as to permit only cushioning and not rigidly pegging the price. See Regulation X-9A6-1.

115. *Hearings before the Committee on the Judiciary on Short Selling*, 73d Cong., 1st Sess. (1932); *Hearings before the Committee on Banking and Currency on S. Res. 84*, 72d Cong., 1st Sess. (1932). No actual bear pools were uncovered. TWENTIETH CENTURY FUND, INC., *THE SECURITY MARKETS* (1935) 504.

116. See *Hearings before Committee on Banking and Currency*, *supra*, note 115, at 187-98.

117. Securities Exchange Act Release No. 1548, Jan. 24, 1938.

118. The defense of short-selling conducted by Richard Whitney, former President of the New York Stock Exchange, during the Senate investigation was complicated by the lack of exact figures on the volume and timing of short selling. See *Hearings before Com-*

although it may be doubted whether short selling has any long-term effect in depressing market levels.

After an initial period of regulation under rules promulgated by the national exchanges, the Commission decided further restrictions were necessary. The decision was made after a study of short selling during the 1937 market break, which tended to show that short selling accentuated the decline, particularly in market leaders. A rule was therefore formulated which strictly limited short selling even on stable or rising markets and virtually prevented it on a decline.¹¹⁹ This rule was later changed to loosen the restrictions on stable or rising markets but to retain a strict limitation when prices are declining.¹²⁰

The importance of short selling as a manipulative device today is negligible. Although Section 9(a)(2) was written to cover manipulation of security prices down as well as up, no cases have arisen since the passage of the Act involving manipulation to depress the market price.

THE OVER-THE-COUNTER MARKET

The distinctions between the control of manipulation in the over-the-counter market and on organized exchanges spring mainly from the differences in the markets themselves. An organized exchange centers buying and selling of a security in a single market with physical facilities for quick execution of orders and widespread publicity for the price and size of each transaction. In the over-the-counter market trading is dispersed into a large number of separate markets and there is less widespread publicity given the facts of each transaction. Short selling is no problem here. But market sponsorship is of much greater importance in the over-the-counter field than it is on organized exchanges.¹²¹

The control of manipulation in the over-the-counter markets is primarily based on Sections 10(b) and 15(c)(1) dealing with "manipulative or deceptive" and "manipulative, deceptive, or other fraudulent" devices and con-

mittee on Banking and Currency, *supra* note 115, at 113. Figures are now published regularly by the New York Stock Exchange on the volume of short interest at intervals of time, but for a thorough understanding of the effect of short selling it is necessary to study day-to-day changes in individual issues, as was done by the Commission preparatory to the adoption of Commission rules on short selling in 1938. Compare ROSS, *SPECULATION, STOCK PRICES AND INDUSTRIAL FLUCTUATIONS* (1938) 139 with MEEKER, *SHORT SELLING* (1932) 139.

119. Securities Exchange Act Release No. 1548, Jan. 24, 1938.

120. Securities Exchange Act Release No. 2039, March 10, 1939. The amended rule allows short sales at the same price as the last preceding long sale price provided such last preceding long sale price was higher than the last different price which preceded it. The effect is to bar short selling of any issue the price of which is dropping except during rallies. A further restriction on short selling is contained in Section 16(c) which forbids short selling of a corporation's stocks by officers, directors, or principal stockholders.

121. For a recent discussion of the over-the-counter market and the legal controls of other practices than manipulation see Lesh, *Federal Regulation of Over-the-Counter Brokers and Dealers in Securities* (1946) 59 HARV. L. R. 1237.

trivances. By definition and interpretation the Commission has expressed its belief that encompassed within these sections are grants of power sufficient to extend to over-the-counter securities the same protection as is afforded securities subject to Section 9.¹²² In 1935 this viewpoint was crystallized in a rule¹²³ which declared unlawful any act or omission to act in connection with the purchase or sale of an unregistered security, which would violate Section 9 if done with respect to a registered security. However, the Commission quickly suspended the effectiveness of the rule insofar as it applied to over-the-counter securities because of protest from the industry. It was contended that Section 9(a)(2) in its present form was designed for the problems of exchange trading and was not suited to over-the-counter problems.¹²⁴ Successive postponements of effectiveness were eventually followed by cancellation.¹²⁵ The Commission, however, continued to maintain that the substantive law was unchanged by the cancellation, that transactions in unregistered securities which would be violations of Section 9(a)(2) if in registered securities are equally illegal under Sections 10(b) and 15(c)(1), and that such transactions were in fact illegal at common law.¹²⁶

Insofar as this viewpoint regards the provisions of the Act regulating manipulation by purchases and sales as codifications of the common law, it rests upon an insecure basis.¹²⁷ In view, however, of the statutory authority of the Commission to proscribe by definition those activities which violate Sections 10(b) and 15(c)(1) there is no reason to believe that the common law is a determining factor in the substantive law under the Act.

The more difficult question is how far the law which has been developed in the setting of exchange trading should be applied to the over-the-counter field. In the first two cases which involved over-the-counter manipulation, broker-dealers were suspended from the N.A.S.D. for manipulating the price of stocks, blocks of which they were in the course of distributing.¹²⁸ In each case the dealer, who was quoting the stock in the National Quotation Service and newspapers, edged up his bids and actually purchased stock on a rising price scale, thus effectively raising the market price preparatory to a public distribution of the same stock. This conduct the Commission held to be the equivalent of a series of transactions raising the market price of registered securities to induce the purchase of such securities by others,

122. See *In the Matter of Barrett & Co.*, 9 S. E. C. 319, 328 (1941). On the control of manipulation in over-the-counter markets generally see Andreson, *Manipulation of Over-the-Counter Securities Markets* (1942) 10 GEO. WASH. L. REV. 639.

123. Rule GB4, later renumbered Rule X-10B-4. Securities Exchange Act Releases No. 1680, April 29, 1938, and No. 1887, Oct. 1, 1938.

124. Securities Exchange Act Release No. 1689, May 3, 1938.

125. Securities Exchange Act Releases No. 2904, May 23, 1941.

126. *In the Matter of Barrett & Co.*, 9 S. E. C. 319, 328 (1941).

127. See note 37 *supra*.

128. *In the Matter of Barrett & Co.*, 9 S. E. C. 319 (1941); *In the Matter of Masland, Fernon and Anderson*, 9 S. E. C. 338 (1941).

which would violate Section 9(a)(2), and hence also violated Section 15(c)(1). The failure to disclose to purchasers that the market price was so affected was also a violation of Section 15(c)(1).¹²⁹

In view of the distinctions between exchange trading and over-the-counter trading, the application of the principles developed under Section 9(a)(2) to over-the-counter trading is a matter of great difficulty for lack of a dependable standard against which to measure the suspect activity. For instance, in determining whether the activities of an over-the-counter dealer have created active trading in a security or raised the price of the security, the standard may be a volume of trading activity and a price which only the dealer himself has previously maintained. It seems that a far more adequate basis of liability under many circumstances will be the failure to disclose to purchasers that the trading activity and the currently quoted price have been on an increasing scale, the second ground for the Commission's decision. Nevertheless, the opinion in the second case specifically grounded the decision on both a fraud and a public interest theory of manipulation.¹³⁰ It seems, therefore, that the standards of exchange trading are to be applied wherever there is what may be described as an independent market.¹³¹

The impact of these legal controls on the over-the-counter market is chiefly in the direction of curtailing the scope of market sponsorship. In a broad sense the whole structure of over-the-counter trading is built upon the practice of market sponsorship. Insofar as an issue may be actively traded by several independent dealers, it departs from the status of a sponsored issue, but when it develops an active independent market it will normally be listed on an exchange. It is here that some of the heaviest criticisms have been leveled at the Commission's interpretation of the Act. It has been said that the restriction of sponsorship has resulted in the underpricing of outstanding issues resulting in a direct injury to present holders and in an indirect injury to the issuer in that future financing is hampered.¹³²

The actual restriction on the activity of a sponsor is real enough. He is forced to take a position in a security and maintain it. If he allows the price to drop for a time and then commences purchasing which raises the market price again, he will be unable to sell any of his accumulated inventory until he has remained out of the market long enough for the price to readjust itself

129. See Rule X-15c 1-2 (b).

130. In the Matter of Masland, Fernon and Anderson. 9 S. E. C. 338, 344 (1941) ("... the anti-manipulation provisions of the Securities Exchange Act are directed not only against the defrauding of unwary investors but with equal force against the impediments to a free and open market created by artificial stimulants or restraints.")

131. See In the Matter of M. S. Wien & Co., Securities Exchange Act Release No. 3855, Sept. 17, 1946. Compare In the Matter of Norris and Hirschberg, Inc., Securities and Exchange Act Release No. 3776, Jan. 24, 1946 (no independent market found).

132. See letter by L. H. Spalding in 8 INVESTMENT BANKING 249-50 (1938); Daly, *Secondary Market Death Sentence* (1938) 8 INVESTMENT BANKING 194-6 [criticisms directed primarily to the impact of Section 9(a)(2) on sponsorship of lesser-known, exchange-traded issues, but applicable to the over-the-counter market also.]

to supply and demand originating from others; if he sells at a price which is still affected by his own trading activity, his action is open to the interpretation that his purpose was to induce purchasing by others.¹³³

CONCLUSION

The history of the legal controls of manipulation before 1934 indicates clearly that the reforms embodied in the Act were long overdue. The creation of an enforcing agency was probably the most significant step taken, although important advances were made in the substantive law to be enforced. By proceeding with relative caution, case by case, the Commission has achieved a maximum of effective regulation with a minimum of actual enforcement proceedings, despite the fact that difficult problems were encountered in the interpretation of such provisions as the ban on manipulation by actual purchases and sales, qualified as it was by the implied legalization of stabilization. The absence of large scale manipulation cases in recent years, particularly on organized exchanges, leads to the conclusion that compliance with the rules has become easier and virtually complete. The lack of such cases further suggests that manipulation played little or no part in stimulating the 1945-46 securities bull market. Nor is there reason to believe that it has played any significant role in the recent declines.¹³⁴ The short selling rules, which seriously limit all short selling while prices are dropping, seem adequate to control the lesser problem of manipulation by short selling. These conclusions indicate that future analyses of the operation of the securities markets may focus upon the more fundamental problem of the proper function of speculation itself, undiverted by the problem of the market "abuse" of manipulation.

133. Securities Exchange Act Release No. 3056, Oct. 27, 1941.

134. But see statement by Representative Sabbath of Illinois and reply by James J. Caffrey, Chairman of the S. E. C., on the September market decline. *N. Y. Times*, Sept. 8, 1946, § 1, p. 1, col. 1; *The Commercial and Financial Chronicle*, Sept. 19, 1946, p. 1456, cols. 4, 5. Representative Sabbath suspected that the decline had been engineered by short sellers for political purposes; Chairman Caffrey doubted that short selling was responsible.