INTRODUCTION

The National Association of Securities Dealers, Inc. will complete in August, next, the first ten years of its existence. These were the formative years and it appears appropriate that at this time the Board of Governors should examine the record of the Association in order to determine its accomplishments and its omissions in relation to the problems that lie immediately ahead.

There is presented herewith a review of some of the more important aspects of the Association's work during the past decade. It does not purport to reflect everything which has been accomplished.

The work of the Association naturally divides into three distinct parts: Administrative, Regulatory, Supervisory. Each of these have been covered in the review and report. Some of the matters touched upon here have received serious consideration by NASD in the past but have not been brought to full realization. They are discussed herein because they represent problems which may again confront the Board in some phase of its work.

The report is intended to assist members of the Board of Governors to become conversant with Association affairs, and to serve as background in solving the problems of the future. Inasmuch as incoming members may be unfamiliar with certain activities, the review is more detailed in some respects than might appear essential, but every effort has been made to hold it to minimum length and to the necessary facts.

January 17, 1949

EXAMINATION AND ENFORCEMENT PROGRAM

In considering the examination and enforcement work of the Association it should be remembered that when the Maloney Act of 1934 was adopted in 1938 the business was confronted with a situation in which it could accept one of two alternatives. The alternatives postulated by the Securities and Exchange Commission at that time were either to set up, pursuant to statute, a bona fide effective self-regulatory mechanism or have the government, through the Securities and Exchange Commission, greatly increase its examination and regulatory activities, not only with relation to fraudulent types of activities, but also on a proposed extension of the then effective statute to cover unethical business practices. The Maloney Act Amendment was adopted, perhaps as a lesser of two evils. In any event the enforcement work of the Association has considerable bearing on the effectiveness of the concepts then prevalent and still generally accepted.

The Association's Examination and Enforcement Program, as such, developed slowly. The first year involved primarily the organization of the Association, and an endeavor to develop discussion and understanding of the Association's rules and to familiarize the membership with the problems of the business. There were, however, a certain number of complaints handled informally. In the first eight months of the Association's activities there were 28 different matters brought before the District Business Conduct Committees on an informal basis. These were customer complaints or references from the Securities and Exchange Commission and were not formally handled as violations of Association rules.

The first enforcement activity of a formal nature on a large scale involved the filing of formal complaints against 91 member firms in connection with the Public Service Company of Indiana matter. These were

filed in 1940. A considerable amount of time of the Association officers, District Business Conduct Committees and staff personnel was devoted to the P.S.I. matter until the middle of 1941. The Association's actual Enforcement Program, as it is now known, really commenced in 1941 at the direction of the Board of Governors at the January meeting. In that year a comprehensive plan was developed along two lines: first, to continue the educational work of the various District Committees and second, to ascertain what the actual enforcement problems of the Association were, together with the extent and degree of violations of the Association's rules and Federal and State regulations. Field secretaries or examiners were hired on a full or part-time basis during that period for Districts 1, 2, 5, 7, 8, 10, 11 and 12 as well as for the Executive Office, and the Association commenced a program which involved examination, by a personal call, of every member of the Association.

In connection with examinations some experimentation in types and methods of examining was necessary. In District #2 and #14 Certified Public Accountants were employed to examine members' books and records. In District #8 all of the members were examined by either Association examiners or accountants. All of the members in Districts #3 and #4 were examined by teams of Association examiners who went into the districts for a limited time. District #8 also experimented with a questionnaire.

The result of the first year's intensive examination program disclosed that at the beginning, at least, it would not be practical to cover all members annually by personal examination. It was also discovered that a large number of the type of problems or apparent violations of rules could be ascertained by a questionnaire examination. The greatest number of problems revolved around findings that sales were made to customers at

prices which might not be fair, the failure to maintain proper books and records, a misunderstanding of the technical requirements of the rules relating to confirmations and hypothecation of customers' securities and, in some instances, misuse of customers' funds. It was felt after a year's experience that those problems relating to misunderstandings of books and records rules and of confirmation requirements could be handled by continuing the education program through the NEWS, and through personal contact with the members by the secretaries and the District Business Conduct Committee members.

Because of the problems incident to the outbreak of the war and for lesser reasons the Association in 1942 instituted a questionnaire program. In that year, questionnaires were sent out by individual districts and evaluated by them. These questionnaires were comprehensive in scope and brought to light, among other things, some of the problems relating to inadequate capital and information on pricing policies. Insofar as mark-up policies of members were concerned, the various committees asked for a series of consecutive transactions on the theory, which proved to be well founded, that if the member was charging prices which were not fair, illustrative transactions would be disclosed in any sufficiently large series of consecutive transactions.

Through this period from 1940 through 1942, the Association also handled references from the Securities and Exchange Commission resulting from examinations in the field conducted by Securities and Exchange Commission examiners. The Commission then and still does make it a practice of referring matters to the Association which indicate possible violations of the Association's rules but which do not, in their opinion, indicate fraudulent activity sufficient to warrant revocation proceedings by the Commission itself.

Thus it will be seen that in the formative period the following methods were used in effectuating the examination and enforcement phase of Association activity:

1. Meetings with members to acquaint the members of the Association with the problems.
2. References from the Securities and Exchange Commission.
3. Personal examination by Association examiners.
4. Examinations by Certified Public Accountants.
5. Examination by questionnaires.

Attached hereto as Exhibit #1 is a chart which sets forth the complaints of a formal nature filed since 1939 by each district by year. This chart does not include the complaints arising out of the Public Service of Indiana matter. It is to be noted that the 120 formal complaints filed in 1941, the first year of the Association's concerted program, represent only the more serious situations. In addition there were innumerable instances in which District Business Conduct Committees cautioned members with respect to their practices. Such caution covered items such as books and records, improper confirmations, inadverent hypothecation of customers securities, and violation of technical rules of federal and state regulatory agencies. For example, 1941 in one district in which all members were examined, 5 formal complaints resulted but almost every other member received a letter stating that the member was not in compliance either with the Association or Federal or State regulations in one or more categories.

The complaint and enforcement program developed into a fairly set pattern. Attached hereto as Exhibit #2 is a chart setting forth the causes for complaint by sections of the Rules of Fair Practice from 1939 to date and the disposition of complaints filed. It is to be noted that with the

exception of Section 1 of Article III of the Rules of Fair Practice, the frequency of causes of complaint were in the following order: Section 4, Section 18, Section 12, Section 19, Section 2 and Section 21.

Section 4 requires members to deal fairly with customers in the purchase and sale of securities.

Section 18 prohibits fraudulent, manipulative or deceptive activities in connection with the purchase or sale of securities.

Section 12 provides for certain disclosures on confirmations at or before the completion of the transaction.

Section 19 is a prohibition against the misuse of customers' funds and securities.

Section 2 relates to the propriety of recommendations for the purchase or sales of securities to or for customers.

Section 21 is a general provision relating to the keeping of books and records. In many instances violations of Section 21 were not alleged by district committees in complaints, because of the technical nature of the violations.

On the chart, Exhibit #2, there are disclosed 291 different violations of Section 1. This results in part, from duplications, inasmuch as the practice was early established of alleging an additional violation of Section 1 if other Rules of Fair Practice were violated. In all, exclusive of Public Service of Indiana, 748 causes for complaint have been alleged in 323 separate and distinct complaints. As shown on Exhibit #1 the peak period in the Association's enforcement work was during the years 1941, 1942 and 1943 during which period 227 complaints were filed.

In addition to the handling of formal complaints, the Association through arbitration and informal proceedings also arranged for substantial refunds to customers. In the same time there were 74 fines, resulting in a total collection, exclusive of P.S.I., of $40,572.53; 11 firms signed

compliance statements promising future observance of the rules; 77 member firms were censured; 16 firms were suspended; there were 67 expulsions and 96 cases in which complaints were dismissed; 59 cases were reviewed by the Board of Governors and 7 cases were appealed to the Securities and Exchange Commission. There were 180 hearings held before District Business Conduct Committees and the Board of Governors in connection with these matters, besides innumerable conferences.

One of the results of the enforcement program was the endeavor in 1942 to adopt a capital requirements rule, which proposal is discussed at length elsewhere in this review. The Board of Governors adopted and submitted to the membership in May 1942 a rule, requiring as a requisite to membership, a minimum of $5,000 capital or $2,500 capital in the instance in which the member did not handle customers' funds or securities. This amendment was adopted by vote of the membership. It was subsequently disapproved by the Securities and Exchange Commission. This did result in the adoption of X-15C3-1, the capital ratio requirement rule of the Commission. The reason for the proposal by the Board of Governors of the capital requirements rule was that in too many cases where customers were charged unfair prices, or customers' funds or securities were misused, or in which improper recommendations were made to customers in light of the circumstances, it was noted that capital was small or not adequate. In connection with members' financial responsibility, the Association was able to take action in a certain number of cases in which members were found to be insolvent. Committees uniformly took the position that for a member to handle customers' funds or securities or to do business with the public at a time when it was insolvent constituted conduct inconsistent with just and equitable principles of trade and thus a violation of

Section 1 of Article III of the Rules of Fair Practice. This approach was helpful but admittedly it is not a complete answer to the problems of financial responsibility.

Another problem which these early cases quickly disclosed, particularly with relation to so called "long profit" cases, was the situation, in which, in many instances the firm involved was at the mercy of one or more salesmen. From these and other situations, there developed the present requirements in the By-Laws relating to registered representatives.

Formal complaints, informal complaints and Commission references have dropped off in the period from 1943 to date. Reference to the Exhibits #3, 4 and 5 will disclose almost the same instance of decrease in Commission references as decrease in the Association's formal complaints. Contributing to this decline was the fact that there was a decrease in membership during the war; and the fact that both the S.E.C. and the Association had to limit their activities during the war because of lack of personnel. To a larger extent too, it was due to a raising of standards of the business, as a result of the Association's activities and the increased awareness of the membership of proper standards of the business.

One very important, if not the most important, factor in relation to this situation was the development and final evolution in 1943 of the 5% philosophy by the Board of Governors. Briefly, the background of that philosophy is this. From the time of the first announcement of the Association's enforcement and penalties for violations of Section 4 resulting from the sale of securities to customers at unfair prices, queries were made to members of the Board, District Committees and District Business Conduct Committees as to what constituted a fair mark-up. The response to these queries could be expressed, in general terms, in a statement that a fair mark-up depended on all the given circumstances

and situations. Included in these circumstances, of course, were the then prevailing market, the degree of sophistication and knowledge of the customer, the size of the order, the number of dollars involved in the sale or purchase, the cost of the security by individual unit, and the availability of the security on the market. One of the earlier chairmen of the Board in response to an inquiry of a member as to what constituted a fair profit replied, "That profit is unfair which, if disclosed to three responsible members of this business, would shock their conscience".

Through examinations and through resulting statistics it was disclosed that the overwhelming majority of transactions in the over-the-counter market were consummated at mark-ups of less than 5%. Therefore, in 1943, when the pressure for a definition of a fair profit or mark-up was at its greatest, the Board of Governors enunciated the 5% philosophy. Since that time a constantly increasing proportion of all transactions has been consummated at 5% or less and as a result the number of complaints, relating to unfair prices, have dropped. See Exhibit #3. That decrease is in direct relationship to the decrease in complaints based upon alleged violations of other rules and is indicative of the fact that members of the Association have raised their standards and are to a much greater degree today, than ever before, abiding by what is regarded as ethical and proper conduct in their business.

One of the advantages of the Association's examination porgram, and one of the uses to which resulting statistics have been put, was the response in 1942 to the proposed Commission rule X-15C1-10, which is discussed elsewhere in this review. This rule would have required certain disclosures of mark-up or market in principal transactions with customers. The business was uniformly of the opinion that such a requirement would be disastrous, not only to the business, but to the public and would

result in the impairment of the proper functioning of markets. The Board was able, because of these statistics and because of a knowledge of the problems involved in the over-the-counter market, to demonstrate to the Commission that the proposal was unwarranted and unnecessary.

The knowledge of practices and problems of the business is greater today than ever before and has been and will continue to be of great assistance in dealings with governmental agencies when restrictive doctrines are proposed.

CAPITAL REQUIREMENT RULE

The subject of minimum capital requirements for members of the Association has always been one of paramount importance and, as such, reached a climax in the year 1942. The problem was the basis for lengthy discussion within the Association and also frequently received S. E. C. consideration. The Commission under the 1934 Act was empowered to promulgate rules affecting the financial condition of exchange members and other broker/dealers who did a business through such members, and, at the time of the passage of the Maloney Act Amendment, Congress also authorized the Commission to prescribe capital requirements of general applications in the over-the-counter business. However, no applicable rules or regulations had been promulgated. The Commission did say, however, in an opinion issued permitting the registration of the Association that, "the Commission hopes that the applicant will undertake within the not too distant future the task of insuring its members' solvency. Of course, it must be borne in mind that the Commission may find it necessary to promulgate its own rules as to the financial condition of all registered brokers and dealers, whether or not members of the Association."

As a result of the experience obtained from the enforcement program conducted by the Association in the early years of its existence the Board of Governors was prompted to consider the subject of minimum capital requirements as one means of raising the standards of the securities business. The Board was motivated by the fact that the enforcement program disclosed that members often had only meager capital or no capital at all. Such members found it difficult to avoid the temptation of taking inordinate profits in transactions with customers, since such profits would help to restore a favorable balance on the member's financial statement. The Board felt that a Minimum Capital Requirement Rule would serve to obviate certain abuses existing in the business and would be a sound step toward protecting the public interest. Certain objections naturally existed toward such a rule. The principal objections were that the Association had been set up as a democratic organization and that such a status would be impaired by the elimination of certain dealers whose financial stability was questionable; that tied in with minimum capital requirements would be the question of publicity of statements disclosing members financial condition; that there was a question whether the minimum capital to be required should be expressed in dollars or whether it should be related to the volume of business done and the amount of obligations involved, and whether the dealer did a cash or margin business.

The Board realized there was nothing new about the question of capital requirements since limitations had been demanded in some form by most of the large stock exchanges and by the "blue-sky" laws of various states. For the purpose of sounding out sentiment the question was formally raised at a meeting of the Board in September, 1941. It was recommended that a survey be made by the Executive Director and by Counsel to determine the

feasibility and propriety of formulating a Capital Requirement Rule.

A report was made to the Board in January, 1942 which provoked heated discussion. As a result Counsel was authorized to draft a proposed amendment to the By-Laws of the Association setting up a Minimum Capital Requirement Rule for members and to conduct informal conferences with the staff of the S. E. C. on the matter.

The proposed amendment was based upon a contemplated $5,000 capital as requisite for membership in the Association. This particular amendment was but one of twenty some changes contemplated at that time in the revision of the By-Laws and Rules of the Association.

Prior to the next meeting of the Board in 1942, several meetings were held with the staff of the S. E. C. at which certain changes in the tentative draft of the new amendment were suggested. At the same time a survey was made of reports of examinations of members which had been conducted by the staff of the Association or by certified public accountants, of questionnaires which had been sent to the members in some of the districts and of reports from various state securities commissions. From these sources it was estimated that roughly 25% of the members of the Association would be affected if a $5,000 Capital Requirement Rule were to be set up. At the meeting of the Board in May, 1942 the draft of the proposed amendment was presented to the Board and it was unanimously agreed to submit the proposed amendment to the vote of the members of the Association at the earliest possible moment. The amendment provided for a minimum of $5,000 net capital for those members who cleared their own contracts and a minimum of $2,500 net capital for those members who exclusively cleared through others.

The proposed amendment along with twenty-six other changes in the By-Laws and Rules of Fair Practice was presented to the members for vote

in June, 1942 and with respect to the Capital Requirement amendment the vote was as follows: with 73.3% of the members voting there were 1,197 ballots cast in favor of establishing a Minimum Capital Requirement rule and 738 ballots cast disapproving. It being necessary to obtain S. E. C. approval, the amendment, together with the results of the balloting, was presented to the Commission in July, 1942. The Commission called for a public hearing to obtain expressions from interested parties before it would approve or disapprove. The Commission's subsequent action was double-barreled. In a release dated October 28, 1942 it not only disapproved the proposed amendment but also took occasion to announce that it had developed its own net capital rule and was about to promulgate one which would require the yearly filing of financial statements by registered brokers and dealers. In the opinion of the Commission, disapproving the amendment, it was stated that the proposed amendment was inconsistent with the general purposes of the Securities Exchange Act of 1934 in that associations covered by the Act were intended to be thoroughly democratic and that, in effect, the proposed amendment was discriminatory in making size a criterion of selection of membership in the Association.

The S. E. C. rule did not provide for a standard minimum capital expressed in dollars but instead provided that a broker or dealer could not permit his aggregate indebtedness to exceed 2,000% of his net capital. It was not until August, 1944, however that the Commission amended this rule to define the terms "net capital" and "aggregate indebtedness".

Under the definition of "net capital" the Commission provided, among other things, that in the computation of net capital 10% of the market value of brokers' securities positions should be deducted. Subsequent to the break in the market in September, 1946 the Commission made it known to the Association informally that it was considering an amendment

to the rule whereby the deduction of 10% of securities values would be increased to 30%. The Commission in attempting to justify the proposed change stated that it felt that the present 10% deduction was an inadequate safeguard against foreseeable market fluctuations. Upon receipt of notice by the Association of this contemplated amendment the matter was presented to the various District Committees for comment and the response from the committees was overwhelmingly opposed to the proposal. The Association has not been called upon to make any further representations to the commission in this matter.

"REGISTERED REPRESENTATIVES"

The question of control of securities salesmen is a problem that has long been in the minds of investment bankers. Under the "Code" the rules required approval by a "Code" Committee before a salesman could be employed by a member.

The subject was first discussed by the NASD at a meeting of the Board of Governors in September, 1941, when the Executive Committee authorized a study of the existing By-Laws, Rules of Fair Practice and Code of Procedure of the Association. Among the subjects to be considered was the question of responsibilities of members in transactions by salesmen and the qualifications of salesmen.

At the meeting of the Board in January, 1942 drafts of proposed rules were submitted, the purpose of which would be to enable the Association more effectively to deal with the problem of employment and supervision of salesmen. The text of the rules closely followed the Investment Bankers Code provisions and is outlined herewith:

1. Members would be prohibitedfrom effecting securities transactions with or for salesmen or employees of another member unless prior consent was obtained from the other member.

After consideration this section was not approved by the Board since it was believed that it could not eliminate certain practices it was intended to prevent and might place a member in an embarrassing positon.

2. Members would not be permitted to employ any person as a salesman unless such person (1) had two years' experience in the securities business, (2) was over twenty-one years of age and (3) was of good moral character. The first qualification could be waived if the person had been employed by the member for a period of at least six months provided the compensation to be paid to the salesman would be a straight salary and would not include commissions upon securities sold. Furthermore the first two qualifications could be waived upon specific approval of the District Committee.

This portion also did not receive the approval of the Board since it was felt that it would provide no additional safeguard and would involve considerable red tape.

3. Members would be required to supervise the sales methods of salesmen, to approve all sales made by salesmen and evidence such approval by written endorsement, and to require that all orders taken by salesmen be subject to acceptance and confirmation by the member.

This portion was approved by the Board and eventually became the present Section 27 of the Rules of Fair Practice.

At the meeting of the Board of Governors held in May, 1942 the Executive Director reported that the proposed amendments of the Association By-Laws, Rules of Fair Practice and Code of Procedure had been submitted to the Securities and Exchange Commission for informal clearance and no changes were made in them. The section relating to salesmen, along with others, received the blanket approval of the Board of Governors. The amendments were submitted to the membership for vote in June, 1942 and approved, to become effective October 15, 1942.

In connection with the salesmen rule the Board of Governors advised the membership that this new rule was proposed out of experience with the enforcement program of the Association. It had been found that, although it is common practice in the securities business for partners or officers of dealers to exercise control over methods and practices of salesmen, a number of NASD members were lax in applying this advisable business policy. As a result complaints were filed against members because of acts of salesmen which in nearly every instance were alleged by the employing member to have been performed without its knowledge and consent. In view of such instances penalties were imposed upon the members for the rule violations resulting from the salesmen's disregard of inherent responsibilities of their job. The Board of Governors concluded after study of such cases, that it would be in the interest of the whole membership if more careful supervision of salesmen were imposed as a requisite to membership in the Association. It was felt that, for the majority of members, the rule would involve no new obligation and that insofar as those members were concerned who would have to begin exercising control of salesmen or increase the extent of such control, the rule would become a valued principle of the member's business and possibly

prevent such member from being faced with a complaint arising out of an employee's carelessness or recklessness, and further, whether these rules were to be adopted or not, the Board recognized that a member has a legal obligation for the conduct of salesmen who are its agents.

At the September, 1943 meeting of the Board of Governors, the question of the Association's authority over members' salesmen was again raised by Wm. K. Barclay, Jr., then Chairman of the District Committee of District #12. He pointed out that during some of the hearings on complaints against members it was necessary to have the testimony of salesmen in order to develop a proper record and their experience had been that salesmen refused to appear on advice of counsel. After much discussion the matter was dropped, in view of the fact that there appeared to be a question of Association power and also the amount of work involved.

However, problems involving salesmen continued to come up and at the meeting of the Board held in January, 1945, the Executive Director stated in his report:

"The problem of proper supervision of salesmen has been before the business for a long time. Some of you may remember that when the Investment Bankers' Code was being drafted, consideration was given to various requirements to prevent a salesman from indulging in practices contrary to the best interests of his employer and the business at large. Consideration was being given in those days to minimum educational requirements, as well as fixed compensation, instead of commissions for salesmen. The NASD initially considered rules to protect members against unauthorized activities of sales personnel, but it was not until 1942 that a Fair Practice Rule of this kind was promulgated and adopted. It does not appear to be a very effective instrument, however, and it is doubtful if the Rule, as a protection for the member, is appreciated. The Rule

actually does no more than specify procedure to be followed by a member to insure observance of the common law, which is, in essence, that a principal is responsible for the actions of his agent.

"Some of our members, we know, continue to operate on the theory that their salesmen are so-called free agents and that the firm which pays them has no responsibility to them or to their customers beyond executing the orders they bring in. Instances have come to our attention of salesmen engaging in practices contrary to the best interest of customers without the Association being able to bring proper measures to bear on the members or the salesmen. In other instances, the confidence of an employing member has been abused to the detriment of the member. Salesmen of members, for example, have engaged in securities transactions with other members without the knowledge of their employer; have given concessions to customers and engaged in other highly unethical practices all beyond our capacity to regulate and, to some extent, beyond the supervisory capacity of the employing member. Further, members have reported to us the difficulty of controlling their salesmen, when a competing organization, more lax in its supervision, is always ready to hire a dissatisfied salesman of another organization.

"However, we regularly hear of one or another form of abuse in which salesmen indulge, allegedly, without the knowledge of the member. And, of course, complaint cases, as often as not, are traceable to the unrestricted salesmen - not that in these cases the member is always without blame.

"Salesmen are responsible for perhaps a major portion of securities turnover. As such they have it within their power to reflect well or ill upon the business which employs them. It would seem to be to the best interests of every member employing salesmen and to the business

as a whole, that fair and proper standards of conduct be required of salesmen and measures be available for disciplining those who depart from them. Disciplinary action that would befall the employing member alone is not sufficient. Even though discharged, a salesman is not removed as a menace to the welfare of the business."

The Board of Governors then appointed a committee headed by Mr. Barclay to make a new study of the By-Laws and Rules with a view to proposing amendments which would bring salesmen within the rules and purview of the Association. After careful study the committee reported back in June, 1945, pointing out that salesmen could employ improper practices in dealing with customers yet evade disciplinary action by the Association since its control extended only to the firm. The committee had consulted counsel and the SEC and therefore recommended extension of the Association's authority to embrace salesmen. The report emphasized that there was no attempt being made to relieve any member from his primary responsibility, adding that "in imposing penalties the committees would only waive the penalty against a member in cases where it would be found that the salesman had exceeded his authority or acted without the knowledge and consent of the house he was representing."

The Board of Governors by unanimous vote approved a resolution to amend the Association's By-Laws and Rules to provide for registration of partners, officers, employees and other representatives of members with the Association as "Registered Representatives."

The amendments were submitted to the membership in July and were passed by a substantial majority of the membership. The vote was 1,022 in favor, 605 against. The amendments were to become effective December 15, 1945. This date subsequently extended to January 15, 1946 in order to allow sufficient time for all individuals to register.

The Securities and Exchange Commission held a public hearing, after this vote, at which testimony was taken both for and against the amendments. The Commission permitted the amendments to become effective in the middle of September, 1945.

On January 2, 1946, thirty dealers, including three who were not members of the Association filed a petition in the United States District Court in New York with the result that the Court issued an order, on January 11, 1946, calling upon the Securities and Exchange Commission to show cause why it should not formally dispose of this matter by means of an appropriate order declaring the amendments effective. The petitioners later withdrew their petition for such an order.

The total registration on January 15, 1946 was 21,351. Since that time there has been a net increase so that as of January 1, 1949 there were 26,562 registered representatives. The record shows that there has been considereble turnover of registered representatives. During 1946 there were 5,238 applications for registration received against 1,746 terminations. In 1947 4,033 registrations and 2,976 terminations, and in 1948 4,262 registrations and 3,600 terminations. Of the total 8,322 terminations only 3,368 have reregistered with another member. The figures here presented would indicate that 10,165 individuals have entered the securities business in the past three years as against 4,954 who have left.

The Association By-Laws provide that membership in the Association may not be approved or continued if the member employs individuals who, by reason of past conduct, have been disqualified from engaging in the securities business through action brought by the S.E.C., a national securities association or exchange. Such restriction may be lifted, however, with the approval or at the direction of the S.E.C. Existing

restrictions were found to be in effect against 24 individuals who filed applications with the Association as Registered Representatives. The applications of 10 of these were withdrawn by the member after they were given notice of the facts. In the remaining 14 cases the member requested and was granted a hearing as a result of which the applications were submitted to the Commission with the recommendation that the member be permitted to continue in membership. The Commission has issued orders approving these recommendations. In two cases, the person barred made application for membership in the Association and applied for registration as a broker/dealer with the Securities and Exchange Commission. These individuals were permitted to register with the Securities and Exchange Commission and subsequently became members of the Association. The Commission restricted one of these individual's activities to acting as agent in all his transactions with the public with the exception of sales of investment trust securities.

There have also been received several hundred applications for individuals who have reported that they were a party to an action taken by a State authority for a violation of a State security law or had been employed by a firm that was so involved. No action has been taken on these because Section 2 of Article I, the Association's authority for action against "Registered Representatives", bars only individuals who were subject to an order of a registered securities exchange or association, or the Securities Exchange Commission and does not specify any restriction to membership based on state action.

Three instances have been noted in which individuals were involved in State actions but were not barred from registration by our By-Laws. However, it was the opinion of the Securities and Exchange Commission that if the member employed these individuals it possibly would be

necessary, in the public interest, to institute revocation proceedings against such members. The Association, in each of these cases, informally advised the member of the possibility of Commission action if these individuals were employed and the member withdrew the applications for registration of the individuals as "Registered Representatives."

Since the registration amendment was adopted there have been 8 complaints filed with District Committees involving "Registered Representatives."

One filed by a former employer of the "Registered Representative" was withdrawn after it was decided the contract prohibiting the salesman from representing another securities dealer for a period of time, was invalid. The other complaints were filed by District Business Conduct Committees. In one case the member was a sole proprietor and as such was expelled and his registration revoked. The complaint against his salesman was dismissed. Two complaints against members were dismissed but the registration of representatives involved were revoked. One member was censured and the "Registered Representative" fined $100.00 and censured. There is now pending a complaint against a member involving two "Registered Representatives."

During the past year the examiners of the Association have been supplied with the names of the "Registered Representatives" of the members to be examined. The examiners have reported numerous discrepancies in the Association's records, mainly due to the fact that members have been negligent in advising the Association of terminations of registrations and in some cases have not filed applications for new employees. It is to be hoped that these discrepancies will diminish as the examiners pursue the policy of advising members of the importance of filing applications and terminations as they occur.

COMPULSORY ARBITRATION

Arbitration has been a matter of active interest to the Board of Governors on several occasions, both as concerns the arbitration of disputes between members and the settlement of differences between members and their customers.

There is today no standardized procedure or formal machinery for arbitration applicable to all controversies although NASD members in adopting the By-Laws have given the Board of Governors authority to adopt such procedure for controversies arising under the Rules of Fair Practice and to delegate to District Arbitration Committees power to act as arbitrator in disputes under the Uniform Practice Code. The Association has been used as a medium in the settlement of members' disputes, but only on an informal basis and only where the involved parties have agreed to be bound by the decision of the committee or group appointed to determine the issues.

In 1943 the Board instructed the Association's Counsel to prepare "formal procedure for the arbitration of controversies between members and between members and the public" and after consultation with others and study of the various problems involved, a draft of the Rules of Arbitration was submitted at the June, 1944, meeting. As this provoked discussion the Board instructed the Executive Director and Counsel to submit additional amendments and to complete a Code of Arbitration for submission to the Executive Committee, which was done after consulting the SEC and District Committees. Two points of the proposed Code caused renewed doubts, namely the compulsory feature and the lack of a right of appeal. As a result the matter was referred to a sub-committee for conference discussion within the various districts. Subsequently the Code was also submitted to the District Chairman for

a report on opinions and views of members. The District Chairmen were informed that the adoption of a Code of Arbitration Procedure would permit the Board of Governors to perform a function contemplated by the By-Laws and to render a valuable service to members and to the public by providing a mechanism whereby controversies could be quickly and economically settled, justice done, the necessity for complaint proceedings avoided, and the necessity and expense of proceedings in the courts avoided as well. When the Board met in June, 1945 and called upon District Chairmen for reports from their respective districts, the majority opinion indicated that the members either had no interest in the adoption of an arbitration procedure or were opposed to establishment of what was considered cumbersome machinery. No further official action has occurred since.

THE UNIFORM PRACTICE CODE

Prior to the inception of the National Association of Securities Dealers, Inc. in 1939, transactions in securities over-the-counter were made and settled on a very informal basis. The firm to which a security was tendered in settlement of a contract had to make its own decision as to the negotiability and acceptability of the security tendered. For many years the national securities exchanges had been formulating rules for delivery and were in a position to impose certain listing requirements upon corporations whose securities were traded on their exchanges. The result was that corporations whose securities were listed on exchanges performed certain of their functions within a definitive framework, so that it was a comparatively simple matter to establish rules. No such situation existed in the over-the-counter

markets. Over-the-counter dealers were obliged to trade in securities of corporations which had varied conceptions as to the physical condition of securities issued to the public and the methods by which such securities could be transferred. Moreover, dealers themselves arranged their transactions so informally that there was often doubt as to the exact terms of their contracts.

The Baldwin Locomotive situation may be cited as an illustration. A "when-issued" market in securities of this company had been conducted during the period in which a recapitalization was in progress. The settlement of these "when-issued" contracts provoked a situation in which the "Street" became aware of the fact that settlement of all contracts on one day would impose a serious financial burden on certain dealers who had made substantial contracts in this issue. The Investment Bankers Conference, Inc. was called upon to provide a solution to this serious problem and through the efforts of that body it was arranged that deliveries could be made in small quantities so that re-deliveries could be effected and by this repeated turnover by firms with limited capital all contracts were settled within a short period.

When the N.A.S.D. was organized in 1939 its sponsors were keenly aware of the problems involved in the settlement of contracts. Consequently, its By-laws contained a clause which vested in the Board of Governors the authority to adopt a Uniform Practice Code designed to make uniform, where practicable, custom, practice, usage and trading technique in the investment banking and securities business. In addition to providing for a Uniform Practice Code the same article provided that the Board of Governors would have the authority to issue binding rulings with respect to the applicability of the Code to situations in

which there was no substantial disagreement as to the facts involved. The Board of Governors immediately appointed a committee to draft such a Code. The problems before the Committee were so complicated that the Code, in its final form, was not adopted and made effective until August 1, 1941.

However, prior to the establishment of the National Uniform Practice Code the Board of Governors was called upon to render a decision in an emergency situation. A plan, dated July 20, 1937, for the reorganization of Follensbee Bros. Co. had run into difficulties and it was necessary to obtain a ruling as to the status of contracts covering securities of this company which were to be issued under the plan of reorganization. After considering all factors involved, the Board of Governors concluded that the contracts could not be completed and an announcement to that effect was made in March, 1940. Some broker-dealers raised the question of their compulsion to accept the decision of the Board, but the fairness of the decision and the right of the Board to make it was generally accepted.

The Committee which had been working on the establishment of the Code was appointed to serve as the first National Uniform Practice Committee and one of the first matters with which it was confronted involved "when-issued" contracts in the securities of Erie Railroad Company. The reorganization of the Erie Railroad had been in process and the securities of the newly organized company were about to be issued. Many dealers had been careless in confirming "when-issued" transactions and had merely stated that they had dealt in Erie Railroad Co. common stock. The certificates which were to be issued were certificates of beneficial interest for common stock and these were selling, in the over-the-counter market, at a price slightly less than the price of

the actual common stock, which was listed on the New York Stock Exchange. Since the issuance of the certificates of beneficial interest was contemplated, it was logical to conclude that the dealers must have been trading in such certificates even though many of their confirmations did not actually say so. In August, 1941, the Committee so ruled and directed that "when-issued" contracts in Erie Railroad Common stock could be settled by the delivery of certificates of beneficial interest.

In January, 1944 the National Uniform Practice Committee found it necessary to issue a ruling on when, as and if issued contracts in securities of the Missouri Pacific Railroad Co. which were to be issued under a plan of reorganization dated April 9, 1940. A Federal Court had stated that the plan was not acceptable and directed that another plan be devised to satisfy the claims of the creditors. In the interim, the Court reserved the right to determine the basis upon which any payments to the old bond holders of the Missouri Pacific Railroad Co. should be applied. On the basis of all the facts before it, the National Uniform Practice Committee ruled that the contracts made under the plan dated April 9, 1940 could not be completed.

Although this ruling was received with great favor by dealers generally, a difficulty arose when the New York Stock Clearing Corporation, which was holding substantial deposits marking Missouri Pacific contracts to the market, decided that the ruling of the Association did not give the Stock Clearing Corporation authority to discontinue the intermediate clearance of contracts and to return funds to those who had deposited them. Their opinion was based upon the belief that the contracts should not have been cancelled until it was possible to compare the plan with a successor plan which was already in existence

and which showed that the securities which were finally to be issued bore no relationship to those described in the contracts. Some discussion followed and the New York Stock Clearing Corporation was finally convinced that any plan which the Courts might subsequently approve could not result in the issuance of securities which were identical to those called for in the contracts.

In August, 1944 the Committee found it necessary to cancel when, as and if issued contracts in securities to be issued by the Chicago, Milwaukee, St. Paul and Pacific Railroad Co. under a plan of reorganization approved by the Federal Courts in October, 1940. Contracts in these securities were also the subject of intermediate clearance by the New York Stock Clearing Corporation. No difficulty was experienced on the discontinuance of this clearance and deposits made with the Clearing Corporation were returned immediately after issuance of the ruling by the Association. However, in 1948 a member of the public filed a suit in the Supreme Court of the State of New York in which he claimed delivery of $10,000. Chicago, Milwaukee, St. Paul and Pacific Railroad 4½% Bonds due 2019 in settlement of a contract calling for delivery of St. Paul 4½% Bonds due 2014, in spite of the fact that the contract had been declared incompletable by the Association. In November, 1948 the Court ruled that the bonds which were issued under the succeeding plan were different from those mentioned in the contract, and stated that the broker-dealer was not required to make delivery as claimed.

This decision was important since the points of difference between the two securities were, to the mind of the layman, somewhat difficult to discern and, since the Court vindicated the judgment of the Committee in this case, it is reasonable to believe that it will be less difficult to substantiate the actions of the Committee in other instances.

The decision of the Court is also important because it was stated that the member of the public was not bound, in this particular transaction, by rules of the N.A.S.D. The confirmations issued to the plaintiff by the broker who purchased the securities for him stated that the transaction was subject to the usages and customs of the market upon which the transaction was made. The plaintiff claimed that the N.A.S.D. was unkown to him and since he had not been put on notice that his transaction was subject to the rules of the Association he could not be bound by its rules. Apparently the Court concurred with that point of view. The decision again emphasized what the Committee has repeatedly pointed out, that is, that transactions in the over-the-counter market between members should be made subject specifically to the rules of the Association and that the customer should be put on notice of that fact.

Also related to the matter is the importance of accuracy and completeness in confirming transactions. The Committee had from time to time published advisory memoranda on this subject and in 1945 deemed it advisable to again bring it to the attention of the members. It published a complete commentary on the confirmation of "when-issued" contracts, in which was stressed the importance of an adequate description of the security which is the subject of the contract, specification of the plan or document under which the security was to be issued, and the inclusion of a condition that the contract be made subject to the rules of the N.A.S.D., if such security was traded in the over-the-counter market. In addition, the memorandum discussed such subjects as accrued interest on bonds, marking contracts to the market and the segregation of funds deposited on contracts. Two types of "when-issued" contract forms were approved. Although this memorandum dealt specifi-

cally with "when-issued" contracts the principles enunciated in it applied also to regular way contracts.

In addition to the cases cited previously there were other matters involving "when-issued" securities upon which the Committee was required to make rulings directing the methods for settlement of contracts. However, activities of the National Uniform Practice Committee were not confined to controversies on "when-issued" contracts. Since its inception the National Uniform Practice Committee has issued 116 rulings and announcements covering all varieties of subjects.

One section of the Code which brought order out of previous chaos is Section 5, which is known as the ex-dividend rule. This section has often been the means of avoiding misunderstandings.

Many companies followed informal methods of declaring and announcing dividends. In an effort to improve this, the Committee, in cooperation with the Quotations Committee, has written approximately a thousand letters in which it discussed such methods and suggested adjustment, so that dividends would be announced well in advance of the record date. Except in isolated instances cooperation from the companies has been gratifying and the methods currently used in the declaration of dividends are greatly standardized.

During the entire life of the Code the National Uniform Practice Committee has been active in its administration and has suggested several amendments to the Code.

In 1944, consideration was given to the amendment of Section 14 in order that it might state clearly the parties who would be expected to accept liability for transfer taxes incurred upon sales and deliveries of securities. Prior to its amendment, the rule was vague on the

point. Neither the National Uniform Practice Code nor the Committee attempts to determine whether a tax has been incurred on a transaction. Such determination is the function of the authority charged with the administration of a particular stock transfer tax law. Section 14 of the Code merely attempts to state who shall be expected to pay the tax if one has been incurred in a transaction.

In 1942 Section 2 of the Code was amended to outline the power of the Committee to issue rulings. In 1946 the section was again amended to clarify it. From time to time other amendments to the Code have been adopted.

The activity of the National Uniform Practice Committee has embraced two particular situations which required continuing attention over the past six or seven years. These related to Central States Electric Corporation and Portland Electric Power Company. In the first instance the Corporation had been placed in the hands of trustees and in 1942 the Court closed the transfer books of the Corporation in order to save costs of transfers which had served to dissipate further the assets of the Corporation. Complete reopening of the transfer books was not directed until 1948. In the interim, many certificates were circulated throughout the "Street" and controversies arose as to whether assignments on these certificates were adequate in meeting the requirements of Section 31 of the Code. The Committee was called upon to review all certificates upon which controversies had arisen and it is estimated that several thousand were so reviewed. Since the reopening of the transfer books none of the certificates reviewed by the Committee has been rejected by the transfer office for deficiencies in assignment.

In the matter of Portland Electric Power Company, disputes arose between members over deliveries of bonds of this company by reason of the failure of the company to make interest payments as they became due. Twice a year from 1941 until 1948 the Committee has issued notices to the membership with respect to coupons becoming void and bonds being a "good delivery".

On April 15, 1946 the Committee approved a set of Notarial Acknowledgement forms which could be used by members when such forms were required and in line with its objective of providing uniformity of practice for the benefit of members, the Committee recently approved a set of six due bill forms calling for the payment of dividends and other distributions.

In April, 1947 the Philippine Government passed its Republic Act No. 62 requiring proof of ownership on all Philippine securities including those which were held by United States owners. The penalty for failure to register such securities was ultimate confiscation by the Philippine Government. The Committee immediately moved into this situation and after some difficulty was instrumental in having the effective dates of the registration postponed several times. In the meantime, it gave sufficient publicity to American holders of Philippine securities to enable them to accomplish the registration required, with the result that American holders of Philippine securities were not deprived of their property.

The Committee was also able to be of some service to members in working out the problems caused by governmental restrictions placed against American and Dutch "looted" securities.

In 1946 and 1947, the Committee was active in obtaining simplification of many of the administrative procedures followed by the New York

State Tax Commission in the assessment and collection of transfer taxes. Inasmuch as the New York tax law was a model for the tax laws passed by five other States, methods of assessment and collection of taxes by State authorities has been somewhat improved.

Federal transfer taxes also received the attention of the Committee over a period of years. In cooperation with other organizations many technical improvements in the payment and collection of Federal Stock Transfer taxes were worked out and accepted by the Treasury Department. One of these eliminated an irritating and time-wasting situation when the Treasury Department permitted the use of the so-called omnibus waiver concerning which all members were notified in 1947. Other successful attempts were made to synchronize and simplify various tax rulings so that complications of transfer were eliminated to some extent.

The Committee has been working for several years on a plan by which the major transfer offices will accept guarantees of assignments made by over-the-counter houses. Progress has been slow because of conflicting views existing among transfer agents, the insurance companies who write indemnity bonds, and the Association itself. The Committee is continuing to probe for a solution of the problems which have arisen in connection with it.

It is apparent that the problems and complications arising in the settlement of contracts have made necessary the adoption of sound and practical rules which would serve as a guide for the members and the Committee. The Code has met that need.

CLEARING HOUSE FOR THE OVER-THE-COUNTER MARKET

The subject of a clearing house for the settlement of contracts

between over-the-counter members has been broached at various times since the birth of the Association and prior to that was considered by a special committee of the Investment Bankers Conference, Inc. Attention was given primarily to the formation of such a clearing house in the New York area and, if that proved successful, it was the intention then to extend the facilities on a national scale.

The proposal was presented to the Board of Governors in the latter part of 1941 at which time the Board authorized the formation of a committee to investigate and report on the feasibility of establishing a clearing house for members. The Committee was composed of members from New York, Chicago, Philadelphia, and San Francisco, with Edgar S. Baruc of New York as Chairman. At about that time there existed wide activity in the field of "when-issued" transactions and it was contemplated that should the clearing house, to be established initially for "when-issued" contracts, prove successful these services could be further extended and developed to handle transactions in issued securities.

As to the location of such a clearing house it was felt that the principal office should be established in the city of New York with branch office facilities to be available in Chicago and San Francisco. The initial cost of establishing the clearing house, whether national or confined to New York was, naturally, a matter of great concern. The problems of organization also covered the question as to whether all the members of the Association should be assessed an amount representing a subscription to the capital stock of the clearing house corporation to serve as a "guarantee" fund or whether the cost should be borne by only those members who would use the facilities of the proposed clearing house. The question of margin guarantees to be deposited and maintained by clearing members posed another problem. The committee advocated that

the mechanics of clearing be handled by the already existing Stock Clearing Corporation of the New York Stock Exchange, with responsibility for contracts naturally to remain with the clearing members of the Association. At that time the officials of the Exchange were not averse to such a proposal.

In preparing this report the committee conferred with representatives of various commodity exchanges, the New York Stock Exchange and interested spokesmen for the banking industry. It also employed Certified Public Accountants, who made a comprehensive study and submitted a report covering the formation of the proposed clearing house. Nine of the largest dealers in New York were requested to submit figures as to their activity over a given period in "when-issued" securities. These houses willingly cooperated and the figures submitted were of great assistance to the committee.

While the study was in progress the exigencies of current war problems over-shadowed and to a great extent undermined the plans for setting up this over-the-counter clearing house. However, the committee continued its study and finally submitted a report to the Board of Governors in May of 1942, in which it was recommended that the Association sponsor a clearing house corporation available to all members of the Association. The Committee was of the opinion that the benefits to be derived from the operation of a clearing house would accrue to the members of the Association as well as to the investing public. Savings in operation would be effected by facilitating the actual receipt and delivery of securities between members and certain protective features would be afforded through control of contracts by a central organization and by margin deposits required to be made by members to support these contracts.

The Board of Governors reviewed the committee report and, feeling that it should exort caution in sponsoring a proposal so beset with technicalities, concluded that the material in the report should be presented to the members of the Association so that they, acting as individuals or as collective groups, could decide whether the matter should be pursued. Subsequently it sent to all members a brief outline of the proposal and requested members to submit their opinions to the committee. The Board at the same time stated that it did not wish to influence members in any way, but that if the rpoposition had been presented in more normal times it would have probably been a strong advocate.

Membership response was apparently apathetic and not until January 1944 was the matter again brought before the Board. It was evident by this time that little interest could be raised by the Board or the membership. It was equally obvious that the matter was of greater interest to the members in the New York area than to those members situated in other parts of the country particularly with regard to the "when-issued" phase since activity in that field was greatest in the New York area. The Board then decided that its members from New York should meet with the committee for discussion and report to the Executive Committee, after which the matter was dropped. Principal factors in the lack of enthusiam were the war situation and the technicalities involved-such as the difficulty of obtaining personnel, lack of adequate space in the various financial centers, and the initial expense.

A quite recent development, described hereafter, has been the extension of the facilities of the Stock Clearing Corporation of the New York Stock Exchange to over-the-counter dealers permitting the delivery of sealed envelopes containing securities, checks, etc. between

such dealers. Successful operation under this arrangement could well provide the stimulus necessary to revive interest in the formation of a general clearing house for over-the-counter members.

CENTRAL DELIVERY - NEW YORK

Operation of a central delivery system for over-the-counter dealers was inaugurated in New York on Nov. 1, 1948, representing the culmination of discussions in progress for many years. The objectives of these discussions were the facilitating of deliveries between dealers and the effecting of economies in day-to-day operations. The first positive action toward these objectives was taken in April, 1948, when the Uniform Practice Committee of District #13 opened negotiations with the New York Stock Clearing Corporation and with the Business Procedure Committee of the Association of Stock Exchange Firms. A series of meetings was held and a formal plan evolved which resulted in the Stock Clearing Corporation adopting an amendment to their rules on Oct. 6, 1948 which made the plan effective.

Actual Central Delivery operations commenced on November 1, 1948 with nine over-the-counter dealers and clearing agents for over-the-counter firms participating. Nine dealers may not appear to be representative but it should be noted that one of the clearing agents, namely, The Trust Company of North America, clears for over sixty dealers, and other clearance agents also participate on behalf of their clients. Furthermore, it is possible for over-the-counter dealers who participate in the plan to make deliveries through the Central Delivery operation to 182 firms which are already members of the New York Stock Clearing Corporation, and to receive deliveries from them through the same channel.

The mechanics of operation of the Central Delivery System, insofar as over-the-counter participants is concerned, differs in one major respect from the normal processes followed by regular Clearing Members. Instead of delivering visible securities to Central Delivery which are verified by actual count, the over-the-counter dealers are required to deliver securities and checks to Central Delivery in sealed envelopes bearing the clearing house number of the dealer to whom they are consigned. A member delivering envelopes to Central Delivery is given receipts for the number of envelopes so delivered and at the same time may pick up envelopes which have been consigned to him by sending dealers. Contents of packages are examined by the receiving member and if determined to be satisfactory as to delivery the receiving member then issues a check in payment and delivers it in a sealed envelope to Central Delivery consigned to the sending dealer. The Stock Clearing Corporation does not participate in the settlement of items delivered through the Central Delivery system and has no responsibility for the payment of such items. The plan, however, does afford a desired convenience in facilitating the delivery of securities and checks.

Participating over-the-counter dealers are assessed a service charge of $25.00 per month plus $.05 for each envelope delivered or received with a minimum total assessment of $50.00 monthly. Advice has been received that since the inception of the plan on November 1, 1948 an average of 400 envelopes daily have been delivered through the Central Delivery System and it is believed likely that the system will expand and gain in popularity.

QUOTATIONS

One of the most important of the many constructive actions by the NASD, in the public interest, has been the development of a system for compiling quotations on over-the-counter securities. Prior to the assumption of responsibility by the NASD such quotations were almost entirely those supplied by individual dealers through special arrangements with newspapers in their respective territories.

The first organized dealer effort to improve the quotation situation was undertaken by the New York Security Dealers Association in establishing its own machinery for gathering and distributing such quotations. In due time this responsibility was undertaken by the National Association of Securities Dealers, Inc., although it was not until September 29, 1941 that the association's National Quotations Committee announced policies governing compilation of newspaper quotations for the guidance of District Quotations Committees. These policies are set forth here:

1. The protection of the public interest shall be the paramount consideration of all members and committees of the NASD in the compilation and supervision of newspaper quotations.
2. The list of securities to be quoted in any newspaper within a District shall be determined by the District Quotations Committee or a sub-committee thereof.
3. The actual compilation of the quotations, whether done by committees or individual firms or otherwise, shall be supervised and approved by the District Quotations Committee or appropriate sub-committee thereof.
4. Each quoted security shall be separately considered

by the District Quotations Committee or appropriate sub-committee thereof. They shall assign a spread to each security based on the committee's knowledge of local market conditions with respect to such security, its activity, type, size of issue, price and other pertinent attributes.

5. In computing the published bid price of a security, two or more of the best actual bids shall be taken into consideration. The bid price to be published shall not be less than the actual bids by more than the equivalent of nominal selling commission.

6. The published asked price shall be determined by adding to the bid price determined pursuant to paragraph 5, the spread which has previously been assigned to the security by the Quotations Committee pursuant to the provisions of paragraph 4.

7. Any member or other person who desires to effect a change in the spread assigned to any security may after showing evidence that he has a substantial interest in the security in question, petition for such a change to the Quotations Committee or appropriate sub-committee supervising the quotation.

Early in the year 1943 the Securities and Exchange Commission began taking exception to the method used by the NASD in compiling its quotations for publication, because they were based upon a formula system superimposed upon the dealers' market. Furthermore, the argument was advanced that in quoting over-the-counter securities, the dealers' market

only should be used. In the following months the subject was debated at some length by parties directly concerned, representing both the Securities and Exchange Commission and the National Association of Securities Dealers, Inc. The subject of fixed spreads finally came up for consideration by the Board of Governors at the meeting in September, 1943, and was referred back to the National Quotations Committee.

Upon further consideration and study of the published quotations problem the National Quotations Committee concluded that, first of all, it should be recognized that there are two distinct markets involved - dealer or professional traders' market and the retail market. And, secondly, that because the over-the-counter market is primarily merchandizing in character, it should be quoted on a retail basis. And, finally, in order to meet the criticism that quotations under the sponsorship of the Association were, because of fixed spreads, fictitious, quotations for publication hereafter should be obtained directly from the dealers, which quotations in each case should represent prices at which said dealers are willing to trade with the public. These views resulted in the following resolution which was adopted by the Board of Governors at their meeting October 2-3, 1944:-

"1. It is the unanimous recommendation of the National Quotations Committee that all newspaper quotations sponsored by the Association be actual prices at which members will trade with the general public.

2. The Board of Governors advise all District and Local Quotations Committees of its adoption of this policy.

3. That the Board of Governors instruct the National Quotations Committee to counsel with District and Local Quotations Committees to the end that this recommendation be

continously in force.

4. That the Board of Governors authorize a reasonable appropriation to underwrite any additional expense incurred in initiating this program with the provision that the National Quotations Committee report back to the Board at its next meeting on progress made and on prospective needs for funds."

In accordance with the foregoing the Chairman of District and Local Quotations Committees were advised by the National Quotations Committee as of November 17, 1944 of the action taken by the Board, together with suggestions as to ways and means for implementing the new policy and also a copy of the masthead to be used, said masthead being as follows:-

"These bid and asked quotations represent prices at which one or more dealers, members of the National Asscciation of Securities Dealers, Inc., would trade with the general public at the time the quotations were gathered, 12 noon (today)(yesterday)."

For the most part, there being but one exception, the new system of compiling quotations for release to the Press under the sponsorship of the Association received the approval and support of the Districts of the Association. At the Board meeting held January 14-15, 1946 the Chairman of the National Quotations Committee was able to report that the new program had been carried out satisfactorily throughout the Association with the exception of one district.

On January 6, 1947 under the direction of the National Quotations Committee a new project was officially begun with the publication in the Wall Street Journal of the approximate weekly ranges of about 450 less

actively traded unlisted securities. Both the Wall Street Journal and the Committee felt that these 450 constituted a group of over-the-counter securities which, although not of sufficient interest to warrant daily published quotations, merited some market representation periodically. The Association agreed to provide this weekly range compilation, the retail prices of which were to be based upon daily dealer markets, and the Wall Street Journal agreed to publish same in their Monday morning editions. It was felt to be very important that the nature of this compilation be very explicit and carefully explained. Therefore the following masthead was designated:

> "The following 'bids' and 'askeds' do not represent actual transactions. They are intended as a guide to the approximate range within which these securities could have been sold (indicated by the 'bid') or bought (indicated by the 'asked') during the preceding week."

This weekly range market has been published regularly to date and has been received with so much interest that its coverage has been materially increased to approximately 600.

When the weekly range list came to the attention of some of the personnel of the Securities and Exchange Commission, the first reaction was that the range markets were actually fictitious quotations. However, it was pointed out that this claim of fictitious quotations could not be applied to the weekly range markets because the 'bids' and 'askeds' as defined in the explanatory masthead were not quotations. Upon analysis it became apparent to the National Quotations Committee that there was little difference between the weekly ranges and the daily quotations except that one was on a weekly basis and the other on a daily basis. The Committee concluded that a similar explanation for the sake of

accuracy should be used for NASD daily published markets. Also it was felt that in so doing, the Association could not in any possible way be accused of publishing fictitious quotations. Therefore, upon authority vested in the National Quotations Committee by the Board of Governors, the following masthead was adopted at a meeting of the National Quotations Committee on April 18, 1947 as official for NASD published markets.

> "The following 'bids' and 'askeds' do not represent actual transactions. They are intended as a guide to the approximate range within which these securities could have been sold (indicated by the 'bid') or bought (indicated by the 'asked') at the time of each day's compilation."

In accordance therewith all district quotations committees were requested to print this masthead at the top of their release sheets and to urge the newspapers in their respective localities to conform with it in their respective headings.

In connection with its quotations work the Association has always recognized the value of published quotations to the over-the-counter market. Naturally the Association depends upon its National Quotations Committee to seek the ways and means of increasing and extending over-the-counter market representation in the financial columns of the press. With this thought in mind the National Quotations Committee has been conducting a survey, the purpose of which is to obtain stockholder distribution data by states on a selected list of Over-the-Counter securities. So far data covering nearly 400 over-the-counter stocks has been obtained. The Committee feels that this information should be of help to Local Quotations Committees in obtaining representation in the financial columns of individual newspapers on those stocks which, by reason of the respective number of residential stockholders, are indicative of

sufficient reader interest. Much of this information has recently been placed in the hands of District Secretaries and their cooperation has been requested for effective use thereof. It is hoped and expected that this will result in increased representation in the over-the-counter market in the newspapers throughout the country.

The present resultant status of activities in connection with the published markets of over-the-counter securities under the sponsorship of the Association is as follows:

1. The present system is in operation throughout most of our Districts with the exception of a few localities where either interest in quotations appears to be more or less dormant or where they are being provided through local trade associations or individual dealers.

2. Based upon data which is still incomplete, it is reasonable to estimate that market-releases to the Press on Over-the-Counter securities under the sponsorship of NASD covers about three thousand issues and appear in about 95 newspapers. Releases are also made to four Press Associations through which services a wide distribution of published markets is obtained.

It is evident that very great progress has been made in the publication of over-the-counter securities markets in recent years. More uniformity of policy and methods of operation have been achieved. Truer and more realistic markets are being reported. Increasing representation of the Over-the-Counter Market in the Press has been obtained.

Further progress is possible and desirable and can be counted upon through the Association's continued active interest in and sponsorship of published markets on over-the-counter securities.

GROUP INSURANCE

The subject of Group Insurance arose frequently at meetings of the Board almost from the Association's beginning but it was not until 1947 that discussions crystallized into action. At the direction of the Chairman of the Board, the Executive Director opened discussions at that time with various insurance companies on an exploratory basis.

Several insurance companies were canvassed and a plan was finally worked out with the State Mutual Life Assurance Company of Worcester, Mass. which was approved by the Board in January, 1948, for submission to the membership.

The State Mutual Life plan finally accepted was a Group Life and Group Accidental Death and Diememberment non-contributory type whereby employers were required to insure all full-time employees, and to pay the entire premium in order to participate. The plan was to be conducted without expense to the Association, and was to be administered on a "trustee" basis whereby the trustees appointed by the Board would receive and accept payments from the members which would be held in a trust fund to provide for payment of premiums due the insurance company. The insurance company agreed to provide an experienced employee, who, initally, would take care of the mechanics of administration and accounting. The initial effective date of the plan was set for May 1, 1948 at which time 199 firms had decided to participate with the insurance coverage amounting to $4,348,500. On January 1, 1949, eight months later, 562 firms were participating. Nearly 3,500 employees on that date were covered by insurance in the amount of $19,027,000.00.

The insurance is available to all full-time employees, actively employed officers, partners, and proprietors irrespective of age and without

medical examination. The plan provides life insurance ranging from $1,500 to $5,000 for employees depending upon wage classification, and $10,000 for actively employed officers, partners, and proprietors with similar amounts payable for accidental death or dismemberment. One feature of the plan is the simplicity of the bookkeeping necessary in administration. This simplification of administration makes possible the premium rate of $1.30 per $1,000 per month, which covers both types of insurance. Among the benefits provided by the plan are optional modes of settlement, the privilege of designating one or more beneficiaries or changing their designation at any time, waiver of premium clause, and the conversion of policies, upon termination of employment, to any normal ordinary policy, issued by the insurance company, except term insurance, at the then attained age without medical examination.

Operation of the plan since its inception has been satisfactory, and the payment of claims has been handled expeditiously. Letters are on file from beneficiaries expressing gratitude for the foresight of the Association in making the insurance available and for the promptness with which claims have been settled. As of January 1, 1949, 16 death claims had been paid in a total amount of $114,500.00.

It should be noted that the rates mentioned previously are those which were in effect for the first policy year. Annually thereafter the combined loss experience of all participating firms will be ascertained by the insurance company and the rates for the ensuing year will be determined on the basis of such experience. Any divisible surplus will be apportioned annually by the Trustees.

An unfavorable loss experience probably would result in higher premium rates. An approximation of the average age of those insured as

of January 1, 1949 was 47 years which is higher than the estimated age upon which the 1948 premium rate was based. This average age of those insured has been decreasing as the larger firms have participated in the plan and it is hoped that the trend will continue so that any necessity for increasing the premium rate will be eliminated.

GOVERNMENT RELATIONS

1. SECURITIES AND EXCHANGE COMMISSION

Any discussion of the Association's relationships with governmental agencies of either state or national character must, naturally, be largely a discussion of dealings with the S.E.C., conferences with respect to various types of proposed statutes, rules and regulations, as well as the impact of the S.E.C., under the law upon the Association's own rules and procedure. Close contact is maintained with the Commissioners and the staff at all times.

In the first instance the representatives of the Investment Bankers Conference, Inc., and the representatives of the S.E.C., jointly worked out the Maloney Act amendment and substantial compromises on both sides were made before sufficient agreement could be developed to submit a statute to the Congress.

With respect to the Association itself the statute provides that the Commission shall have the right to review disciplinary proceedings of the Association; that it shall have the right to review any denial of membership; that it has the specific duty to ascertain that dues are fair and equitably assessed; and that the Commission shall have the power to disapprove any amendment or addition to the By-Laws and Rules of the Association even after adoption thereof by the membership.

The Commission, of course, had to approve the original registration of the Association as a registered securities association and to approve the By-Laws and Rules. Since then there have been a number of amendments to the Rules and By-Laws, Code of Procedure and Uniform Practice Code which have been submitted to the S.E.C. Only one of these has been disapproved by the Commission. That one was the proposed capital requirements rule in 1942.

It is evident that the work with the Commission has involved a day-to-day contact in the handling of affairs of mutual interest but even more than this has been involved. The Association has over the years been a focal point through which NASD membership, representing the investment business, could bring their objections or suggestions to bear for changes in rules and regulations or administration of the statute.

The Association, together with the I.B.A., the New York Stock Exchange and New York Curb Exchange, and in conjunction with the Commission, has since 1940 attempted to find common ground for the submission to Congress of a program for a broad revision of the Securities Acts. The greater necessities of the War program forced abandonment of such efforts in 1942 but discussions were revived in 1946 and have since been in progress. Many meetings have been had by the Committee members and by the staff with Commissioners and staff of the Commission. It is hoped that as a result of these conferences some amendments may be submitted to the present Congress which will meet the difficulties inherent in Section 5 of the 1933 Act. If this hope is realized then other problems will be similarly dealt with in a consultation program.

Problems relating to proposed rules and regulations of the Commission have always had the full consideration of the staff and the appropriate committees of the Association. Customarily consultations are held with

the Commission or its staff in which the Association has been able to present constructive suggestions on behalf of the members. The normal objective of the Association has been to oppose any proposed rule which was considered to be unnecessary and unworkable, and to endeavor to ameliorate the impact of rules which, in the opinion of qualified persons from the business, might perhaps be necessary, but which were not precisely workable in the terms as originally proposed. Probably the most effective manner of presenting the Association's work with the Commission is to review briefly the more important matters of the past decade in which the Association, in the interest of the industry, has seen fit to take action, either as concultant, supporter or opponent.

Much of the Association's work with the S.E.C., has been in connection with the so-called "X-15 C" rules adopted or proposed under Section 15 of the 1934 Act which, in general, are rules applicable to the over-the-counter industry. One of the most controversial proposals was that rule to be classified as X-15C1-10, or as commonly termed the "disclosure" rule. The rule was offered for comment by the staff of the Commission and was not, by its initial terms, a proposal of the Commission itself. It purported to require the disclosure of market prices on transactions with customers under certain circumstances. Many conferences between the staff of the Association and the staff of the Commission were held. The entire membership of the Association was furnished with a copy of the proposal and comments were received which disclosed that the membership was overwhelmingly opposed to any such rule. In the latter part of 1942 a joint meeting of the Commission and the Executive Committee of the Association was held at which the Executive Committee presented, on behalf of the membership, a memorandum expressing the views of the Association in opposition to the proposal. The memorandum, together with

the letter of transmittal, is attached to this report as Exhibit #6. The rule was never adopted and the Commission stated, in a release dated April 2, 1947, "As a result of the comments received in 1942, the Commission determined not to adopt the proposed rule X-15C1-10". It is quite obvious that the efforts of the Association and its representatives in this instance are responsible for permitting the industry to operate to-day without having to bear the onus which would have resulted had the rule been adopted.

Another rule under Section 15 of the 1934 Act, listed as Rule X-15C2-1, relates to the requirements which must be met in connection with the hypothecation or commingling of customers' securities. This rule was made effective on February 24, 1941 and created numerous technical problems. Because of the technicalities involved, the Association, after weeks of concentrated work with the Commission staff, sponsored and conducted dealer forums throughout the country to explain the import and ramifications of the rule. At the same time the Association prepared and sent to the members a memorandum which endeavored to clarify the requirements of the rule.

As stated elsewhere in this review, the Commission, after indicating initial approval, saw fit to disapprove a minimum capital requirement rule of the Association and then proceeded to issue its own Rule X-15C3-1 covering net capital ratio. The S.E.C. rule, however, was implemented by definition after continuing consultations over a two-year period between the Commission staff and a special Association committee and the staff of the Association during which there was an endeavor to make more workable the accounting requirements and procedure originally set forth in the Commission proposal, as well as the definitions contained therein.

Matters under other sections of the Act were given comparable attention. On January 2, 1940 Rules X-17A-3 and X-17A-4 became effective. These rules relate to the maintaining and preserving of specified books and records by brokers and dealers. Here, as in the case of the hypothecation rule, the Association issued an explanatory memorandum to the members describing in detail the nature of the records which the Commission ruled as necessary and, to supplement this, the Association, in 1948, with the approval of the Commission, made available to members a "kit" containing illustrative examples of the manner in which books and records might be kept to comply with the rules.

Rule X-17A-5, which appeared in 1943, covered the annual statements of financial condition to be submitted by brokers and dealers to the Commission. The rule, as it was finally issued, was the composite result of conferences between the staff of the S.E.C., state securities commissioners, the staff of various stock exchanges, the IBA and the staff of the Association. The efforts of these groups were concentrated on the formulation of a type of reporting which, in form and procedure, would be applicable to all brokers and dealers regardless of the system used.

The rules adopted by the Commission under Section 9 (a) of the 1934 Act relating to pegging, fixing and stabilizing were made effective in 1940 and were another example of collaboration with the Commission during the course of a long and cooperative study in attempting to bring about rules which would be workable and with which the industry could comply. More recently, and arising from the Kaiser-Frazer offering, the practical operation of Section 9(a) provided the reason and the basis for conferences between the Association and staff of the Commission. In the belief that the present provisions of the rules were inadequate, insofar as

stabilization was concerned, the Commission called for submission of proposals to modify the rules. A special committee composed of representatives of the Association, the IBA and the Association of Stock Exchange Firms was formed and met with members of the Commission staff to discuss the need, if any, for changes in the rules to cover specific situations which were of concern to the Commission. It was recognized that certain problems did exist but it was the unanimous opinion of the Committee that to attempt to institute more restrictive rules would only serve to create more problems. The Commission staff has apparently concurred with this opinion.

Other proposals of the Commission have been similarly suppressed before reaching the operative stage through the ability of the Association to convince the appropriate representatives of the Commission that a suggested rule or change in rule was not required. One notable example was the proposed rule, offered in April 1946, relating to so-called "free riding". The proposed rule was presented at a time when underwritings were unusually numerous and offerings of securities were being disposed of rapidly in a rising market. Consideration of the District Committees and the Board of Governors resulted in the opinion that the problem, if one existed, could not be handled properly in the manner contemplated by the proposed rule. Subsequently, discussions were had with the Commission and the Association asserted that, through its powers under Sections 1 and 24 of Article III of the Rules of Fair Practice, it could adequately control the situation. Shortly thereafter the general decline in the markets eliminated much of the problem. The rule was not adopted.

Another phase of the Association work with the Commission which is of interest to a very large number of members consisted of negotiations

with the Commission resulting in the adoption of the Investment Company Act of 1940 which generally regulates the manner and mechanics of registration and sales of investment company securities. Section 22 of that Act provides that a registered securities association may adopt rules relating to methods of pricing, redemption and collateral matters. An Investment Trust Underwriters Committee has been in existence since the beginning of the Association and that committee worked closely with representatives of the Commission and the Congress in the preparation of the statute. Thereafter, the Investment Trust Underwriters Committee prepared, and the Board of Governors recommended for adoption, Section 26 of Article III of the Rules of Fair Practice. The rule was adopted by the membership and provides for general mechanics to be used by members in dealing in securities of investment companies. The Commission has never adopted rules, as it has the power to do under the statute, to duplicate or in any way exercise its powers under Section 22 (c) of the Investment Company Act of 1940, primarily because of the effective operation of the Association rule.

More recently the investment company field has provided the basis for further consultive relations with the Commission when, in April, 1948, it criticized charts which purported to depict, in cumulative fashion, the performance of an investment company. Conferences were arranged between the Commission staff and the Investment Trust Underwriters Committee which resulted in Commission permission to use a specific type of chart, with the understanding that additional charts may be used so long as they do not tend to mislead prospective purchasers. The final solution was a fair one and of material value to the securities industry as a whole, as well as to the investment trust underwriters and it served to create better understanding between the Association and the Commission staff.

In 1945 a special committee of the Board of Governors informed representatives of the Commission of the seriousness of a problem arising from the lack of dissemination to dealers of information on new issues. Questions surrounding the utilization of the Red-herring Prospectus provided grounds for continuing discussion between the special committee and the Commission staff until the latter part of 1946. The discussion culminated in promulgation of Rule 131, effective on December 6, 1946, which, in general, permits advance distribution of information without the danger of having such distribution classified as a solicitation.

Another important phase of the Association's work which has had a direct bearing upon relationships with the S.E.C. has been the opposition, in certain specific cases, by the Association to applications filed by the New York Curb Exchange with the Commission for the extension of unlisted trading privileges, pursuant to Section 12 (f) (3) of the Securities Exchange Act of 1934 as amended, to securities not listed on any exchange. Acting upon instructions of the Board of Governors, the Executive Director and Counsel have examined all applications filed by the Curb Exchange under this section of the statute. Consequently, there has been a cessation in the great flood of such applications, exercise of greater selectivity, stronger supporting evidence and more careful supervision by the Commission itself.

The foregoing examples do not purport to disclose the full extent to which the Association has met with the Commission but they are indicative of the manner in which the Association has served as a focal point for the membership in the presentation of suggestions or objections to changes in the Rules, or the administration thereof, under the statute.

2. FEDERAL RESERVE BOARD

The Association's relationship with the Federal Reserve Board has

primarily related to the promulgation and enforcement of Regulation T, adopted pursuant to the Securities and Exchange Act of 1934, as amended. While this regulation was drafted and adopted pursuant to the Securities Exchange Act of 1934 and the Commission has the duty of enforcement, the Federal Reserve Board alone has the power of amendment and interpretation, a fact which at times has caused both confusion and complication.

The major interest of our members in this regulation arises under Section 4 (c) 2 and sections relating to special cash accounts. Section 4 (c) 2, in effect, provides that a customer shall make payment promptly for securities purchased in a special cash account. If such prompt payment is not made, the dealer, after a stated period, is placed under certain specific obligations by the Regulation.

The Association has been instrumental in having amendments adopted bearing upon the granting of time extensions by NASD offices. It has conferred frequently with the Board on matters related to enforcement of the Regulation and is continuing discussions aimed to extend the period to include seven full business days as distinguished from seven calendar days. Relations with the Federal Reserve Board have at all times been satisfactory.

3. TREASURY

Relations with the United States Treasury were closest during World War II, particularly in the early years, when the Association cooperated in every possible way in the various loan drives. Subsequent contact has been almost wholly with the Bureau of Internal Revenue. Constructive action was possible in two important instances, one concerning the applicability of capital gains taxes and, the other, the use of exemption waiver forms.

As to capital gains taxes, the Bureau, in December, 1946, issued instructions to field agents which, in effect, would have made normal income tax provisions applicable to capital gains realized on the sale of all securities by dealers. The Association participated in conferences resulting in an amendment which provided that, under appropriate circumstances, where capital gains were realized on the sale of securities sold out of investment account, only the capital gains tax provisions would apply.

The Bureau, in 1946, issued an omnibus type of exemption waiver form which eliminated the necessity for 18 different exemption waiver forms previously used. This action resulted from representations made by the Association and other organizations at conferences held with the Bureau.

Efforts have been made to obtain relief from the cumbersome method of handling federal tax stamps, so far without avail because of the rigidity of the law.

4. INTERSTATE COMMERCE COMMISSION

Association dealings with the Interstate Commerce Commission have been limited to opposing the rules proposed in 1943, requiring competitive bidding on railroad securities issues. Despite the opposition of this and other associations the rules were adopted.

5. INTERNATIONAL BANK

The Association has maintained close contact with the International Bank for Reconstruction and Development since the Spring of 1947 when initial steps were taken for public financing. The Association supplied detailed information about its membership in order to cooperate in effecting proper distribution of the securities to be offered.

Subsequently, the Bank sought exemption for its securities under Section 3 (a) (12) and Section 15A of the 1934 Act. Upon request, representatives of the Association appeared before the S.E.C. to offer comment. These comments were not of a formal nature and merely pointed out some of the matters which the Association thought the Commission should consider in acting upon the Bank's request. The exemptions were subsequently granted.

In the Spring of 1948 the Association made representations to Congressional committees which conducted hearings upon proposed legislation which would have exempted International Bank securities from the Banking Act of 1933, the Securities Act of 1933 and the Securities Exchange Act of 1934, and would have given their securities substantially the status of exempt securities. The Association advised that it took no position insofar as any direct obligation of the Bank was concerned, but opposed exemption on securities of foreign corporations or foreign governments guaranteed by the International Bank, and opposed amendment of the Banking Act to permit banks to underwrite and deal in these securities. The NASD was the only securities organization which expressed itself at the hearings. Just prior to the start of the hearings International Bank representatives proposed alternatives to the proposed legislation which justified the Association in withdrawing its opposition. The legislation was not reported favorably by the Committee of the House of Representatives at that time.

NASD relations with the International Bank have remained cordial and our attitude is one of cooperation.

6. DEPARTMENT OF JUSTICE

Association relations with the Department of Justice have been in connection with cases in which the Department was interested, one as

intervenor in the Public Service of Indiana case and the other in connection with the investigation of the investment banking and securities business, prior to the filing of the anti-trust suit. During such investigation the NASD files were examined and photostated.

7. CONGRESS

The Association's relationship with the Congress is properly limited to the presentation of the attitude of the membership concerning legislation, proposed or pending. Often NASD has joined with other groups, such as the Investment Bankers Association or the Securities and Exchange Commission in offering such representations to the Congress. Instances where the Association has acted in matters before the Congress are:

The amendment to Section 8 (a) of the Securities Act of 1933, pertaining to the 20-day waiting period, which was the result of the combined representation of the NASD, IBA and the SEC to the Congress.

The proposal, in 1941, by the Association of an amendment to Section 3 (b) of the Securities Act to increase the Regulation A exemption from $100,000. to $300,000. On May 15, 1945 this amendment was adopted.

The joint studies of the industry and Commission in 1940-41 which led to the White Book, and the appearances before the Congress in 1942 with reference to the amendments to the Securities Act, and the Securities Exchange Act.

Efforts by a special committee appointed to work on the Hobbs and Wheeler Bills, eventually vetoed by the President.

The Investment Company Act of 1940--Section 22 (d)-- resulted in Association powers with respect to dealings in investment trust securities as previously discussed herein.

Consultation with the Commission and with the Congress concerning drafts of the Investment Advisers Act in 1940.

Consultations with the Small Business Committee during the war period. As for example, in May, 1943, consultations were had with reference to Regional Stock Exchange, their scope and functions.

Action before the Congress is contemplated concerning revision of the Securities Acts and conferences have been held with the IBA and the SEC since 1946 in this matter. The nature of the problems involved is so complicated that it was felt that if legislation could be introduced, on a step-by-step basis, by representatives of the business and the Commission in agreement, there was greater likelihood that some satisfactory amendment could be obtained. It was agreed that the first section and first problem in the whole amendment program should be prospectus delivery requirements and Section 5 of the Securities Act of 1933.

FORMAL COMPLAINTS BY DISTRICT, 1939-48*

DIST	1939	1940	1941	1942	1943	1944	1945	1946	1947	1948	TOTAL
1			6	2					1		9
2	1	6	11	5	8		1			1	33
3			5	1	1						7
4			11								11
5				1							1
6		1					1	2		1	5
7				1	1			2			4
8		3	21	7	9	3	3	3	1	1	51
9				1	5	1	2		1		10
10			3	3	4	2	2			1	15
11			9	4	1	1	1				16
12			8	5	15	3	3		1		35
13		3	33	13	6	6	4	6	7	6	92
14	1	7	13	4	4	7			1	1	34
TOTAL	2	20	140	57	50	30	17	13	12	12	323

*Does not include P.S.I. Complaints

EXHIBIT #1

NATIONAL ASSOCIATION OF

COMPLAINT SUMMARY
(P.S.I. Not In

DISTRICT	CAUSE OF COMPLAINT																												
	ARTICLE III Sections																									ARTICLE IV Sections			
	1	2	3	4	5	6	8	9	10	12	13	14	15	16	18	19	20	21	23	24	25	26	27	3	4	5	T
1	7			4	1		1								3	2										1	
2	26	3		22	1	1				3	2		1		12	3				1	1						
3	7			5											4	3											
4	10			3						9			1		9			5	1	2							
5	1		1																								
6	3			3						1						1									1	1	
7	4			3												1											
8	50	5		27						8				1	17	6		2		1		1				1	
9	9			9																							
10	14	2		7	3					2	1				3	1									1		
11	15	1		11						6	1				5	4		4	1		1					2	
12	32			30					1	2					7	1		1			1					1	
13	85	5		32	1	5		1		7		1	1		18	5		1	1	6	6					5	
14	28	6	1	22	1	1			3	4			1		7	6	4	1			1	1		1		5	
TOTAL	291	22	2	178	7	7	1	1	4	42	4	1	4	1	85	33	4	14	3	10	10	1	1	1	2	19	7

URITIES DEALERS, INC.

239-1948
ded)

No. of Complaints Involving a Reg. Rep.	HEARINGS		DISPOSITION OF COMPLAINT							APPEALS & REVIEWS	
	DB CC	NB CC	Dismissed	Signed Compliance	Censure	Fine	Suspension	Expulsion	Costs Assessed	Bd.of Gov.	SEC
1	4		1			3	1	5			
1	16	2	10		16	18	2	3	2	4	
	3		4		1	3					
	4	2			9	9		1	1	2	
					1	1					
						3	1	1		2	
					1	3	2				
1	20	7	16	7	10	7	4	9		10	
	8		1		6	5		2			
2	8	2	2		3	8		1	3	3	
	11	4	2		1	1	1	11	2	5	3
2	18	3	12		7	15		1	3	5	
1	37	9	34	3	13	12	7	25	8	22	
	17	15	14	1	9	6		6	2	6	4
8	146	34	96	11	77	74	16	67	21	59	7

EXHIBIT #2

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

COMPLAINTS, 1939-1948*
(*Does not include P.C.I. Cases)

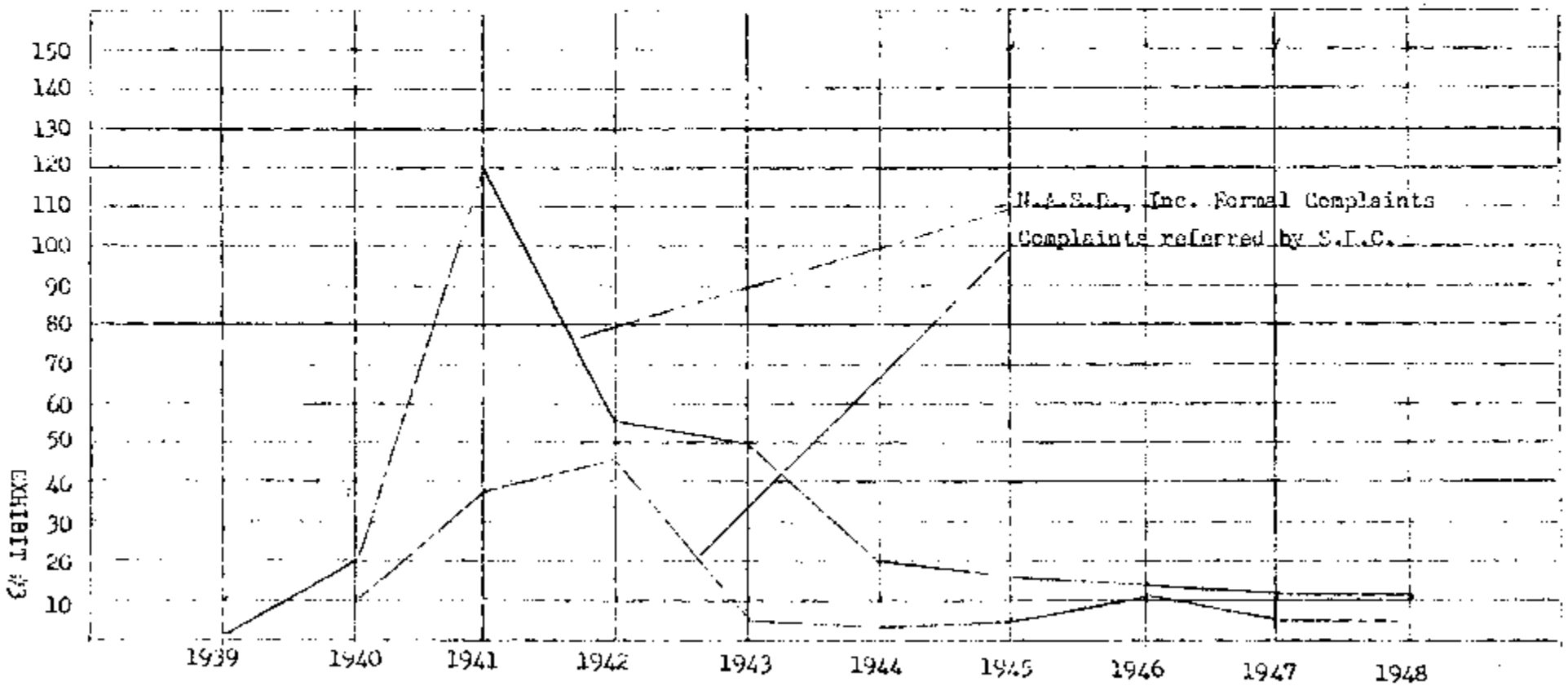

EXHIBIT #3

CASES REFERRED BY S.E.C. TO N.A.S.D. AND THEIR DISPOSITION
BY FISCAL YEARS

S.E.C. Fiscal Year Ended	Cases Pending at beginning of Fiscal year	Cases referred in fiscal year	Dispositions Received in Fiscal year	Cases Pending at end of Fiscal year
June 30, 1940	0	10	10	0
June 30, 1941	0	38	27	11
June 30, 1942	11	46	46	11
June 30, 1943	11	8	18	1
June 30, 1944	1	4	4	1
June 30, 1945	1	6	4	3
June 30, 1946	3	11	7	7
June 30, 1947	7	7	13	1
June 30, 1948	1	7	6	2
		137	135	

EXHIBIT "4"

N.A.S.D. TREATMENT ACCORDED REFERENCE CASES BY FISCAL YEARS

By Formal Complaint Procedure 1/

Fiscal Year Ended	Members Expelled	Members Suspended	Members Fined 2/	Members Censured	Complaints Withdrawn or Dismissed	Total	By Informal Procedure or Other Method 3/	Total
June 30, 1940	1		1	7	1	10		10
June 30, 1941	2	1	1	9	5	18	9	27
June 30, 1942	5	2	9	4	3	23	23	46
June 30, 1943	3	1	3	2		9	9	18
June 30, 1944			1			1	3	4
June 30, 1945			2			2	2	4
June 30, 1946			1			1	6	7
June 30, 1947			3			3	10	13
June 30, 1948			1			1	5	6
Totals	11	4	22	22	9	68	67	135

1/ These cases concern members who may be sole proprietors, partnerships or corporations. Data on the number of partners, other principals or employees concerned in these cases are not available

2/ Frequently fines are accompanied by some lesser penalty such as Censure.

3/ This category includes some cases in which no action was taken on jurisdictional grounds such as termination of membership or because the act cited occurred prior to membership. In addition, rescission was effected in one instance in this category and, in another, a mutually satisfactory price adjustment was arranged. In the majority of cases, however, informal discussion between the appropriate Business Conduct Committee and the member resulted in a decision that no further action was indicated.

EXHIBIT #5

National Association of Securities Dealers, Inc.

1616 WALNUT STREET

Philadelphia, Pa.

H. H. DEWAR, *Chairman* — LEE M. LIMBERT, *Vice Chairman* — ROBERT W. BAIRD, *Treasurer*

WALLACE H. FULTON, *Executive Director*

Board of Governors

ROBERT W. BAIRD	MILWAUKEE	H. H. DEWAR	SAN ANTONIO	BEARDSLEE B. MERRILL	SPOKANE
F. EDWARD BOSSON	HARTFORD	MARK C. ELWORTHY	SAN FRANCISCO	JOHN A. PRESCOTT	KANSAS CITY
EDWARD BROCKHAUS	CINCINNATI	WILLIAM A. FULLER	CHICAGO	ALBERT THEIS, JR.	ST. LOUIS
HAGOOD CLARKE	ATLANTA	W. S. GILBREATH, JR.	DETROIT	CLARENCE E. UNTERBERG	NEW YORK
HERMANN F. CLARKE	BOSTON	B. HOWELL GRISWOLD, JR.	BALTIMORE	E. WARREN WILLARD	DENVER
JAMES COGGESHALL, JR.	NEW YORK	LEE M. LIMBERT	NEW YORK	LAWRENCE B. WOODARD	MINNEAPOLIS
SAMUEL K. CUNNINGHAM	PITTSBURGH	LAURENCE M. MARKS	NEW YORK		

October 20, 1942

Mr. Ganson Purcell, Chairman,
Securities and Exchange Commission,
18th and Locust Streets,
Philadelphia, Pa.

Dear Mr. Chairman:

The undersigned, being the Executive Committee of the National Association of Securities Dealers, Inc., herewith submit in the name of the Board of Governors a statement of views of the Association in opposition to the proposed Rule X-15C1-10.

The views set forth in the memorandum are those of a substantial majority of the members of the Association and, so far as we know, are unopposed by any element of the business.

The ultimate objective of the proposed Rule, we presume, is to secure universal conformance with standards of practice observed by the great majority in the over-the-counter business. We wholeheartedly subscribe to this objective, but we are convinced that neither the immediate nor the ultimate objective sought by the Commission can be attained with this Rule. Our experience of the last two years in self-regulation fortifies our belief that the standards of the securities business can be placed on a high professional level without imposing upon that business further restrictive rules and regulations and that adoption of such further rules and regulations may, indeed, seriously interfere with the process of self-regulation.

The securities business has not just given lip-service to the idea of self-regulation represented by this Association.

EXHIBIT #6

On the contrary, those who have sponsored and supported this idea have invested liberally of their time and money to make it a vital force in the business. They now see, in spite of the convincing results attained, that these efforts, if the proposed rule is adopted, will have been in vain.

If this, or any similar rule, were adopted it would obviate the need for that part of the work of the Association which has represented the greatest part of our service to the industry and the investing public. Therefore, the industry would not support and could not be expected to support an Association whose remaining field of service would be so limited.

Sincerely yours,

H. H. Dewar, Chrm.
Lee M. Limbert, V. Chrm.
Robert W. Baird, Treas.
Hermann F. Clarke
Laurence M. Marks
Mark C. Elworthy

MEMORANDUM

re

PROPOSED RULE X-15C1-10

Submitted to the

Securities and Exchange Commission

by the

BOARD OF GOVERNORS

National Association of Securities Dealers, Inc.

OCTOBER 20, 1942

(Transmittal letter, dated October 20, 1942, addressed to Mr. Ganson Purcell, Chairman, Securities and Exchange Commission, should be read in conjunction with this memorandum)

IN OUR opinion this proposed Rule is unworkable and impracticable but it is not our purpose to discuss technical and mechanical details in this memorandum. Nor, for the purpose of this memorandum, do we intend to examine its legal authority in the light of the intent of Congress and the provisions of the statute. We take issue with the proposal on more fundamental grounds and deny that there is any necessity for such a rule.

We take that position not because of any sentimental urge to defend the securities business against renewed public indictment of its treatment of investors. We take that position as a result of practical experience and out of a knowledge of conditions as they truly exist.

The Commission has been regularly informed of our actions but it would seem appropriate to review again the nature and extent of them as they bear upon the subject of this proposed Rule.

This Association was a little more than a year old when, in April, 1941, it undertook an intensive program of examination of all members and aggressive enforcement of its Rules of Fair Practice.

This program was instituted for two reasons: in the first place, it was believed that such a program was necessary in order to ascertain the nature of the Association's problems; in the second place, it was believed at the time that such a program was necessary to carry out the concept of an industry attempting, with governmental coöperation, to put and to keep its house in order. The word "attempt" is used advisedly. At that time "self-regulation" was only an attempt; today we believe the concept of self-regula-

tion originally held by the Congress, the business and the Commission has justified itself.

In a period of seventeen months well over 2,500 members of the Association have been examined at least once in respect to financial condition and business practices. The Association's staff has employed several means in conducting these examinations.

The Association's staff has personally examined over 500 member firms. In addition, approximately 300 member firms have been examined by Certified Public Accountants trained in respect to brokerage accounting and brokerage practices. Since it was our desire to complete this job of examining the entire membership before the end of the last fiscal year on September 30, 1942, it was decided to examine the remaining members of the Association by questionnaire. The questionnaire employed consisted of two parts, the first covering financial conditions; the second dealing with business practices in general, including questions which would disclose whether the member broker-dealer understood and properly disclosed to his customer the capacity in which he was acting; whether the member understood and complied with governmental rules and regulations concerning the keeping of books and records, the hypothecation of customers' securities, etc.; and whether the member was complying with the Rules of Fair Practice of the Association. The final phase of this second part of the questionnaire included disclosures in respect to sales and profit policies.

The question of fair profit policies and the sale of securities at prices not reasonably related to the market for such securities has been but one phase of the business practices which the Association has carefully examined.

What have been the results of this examination program? In the first place, the Association, acting through its District Business Conduct Committees, has taken disciplinary action against firms in those instances in which their sales and profit policies appeared to be inconsistent with good business ethics. This action has taken several forms. Business Conduct Committees have expelled members from membership in the Association. They have suspended members according as the facts and circumstances warranted. In many instances, members have been fined. District Business Conduct Committees have on occasions been able to effect substantial restitution to customers. In addition to the foregoing, the Association, through its Business Conduct Committees, has, as a result of the examination and study of these reports of examinations and questionnaires, directed letters to firms cautioning them and further advising them concerning the mandates of the Rules of Fair Practice and urging them at all times to consider first and foremost their customers' welfare and secondly the question of their own profits.

Thus, this phase of the Association's work has taken three forms—first, appropriate disciplinary action; second, restitution where feasible and possible; and third, the continued efforts to promote a universal awareness of the responsibility of brokers and dealers to deal fairly with their customers.

The Association, through its Business Conduct Committees, is engaged in advancing the theory that a profit in this business must be based on service. This has been the established policy of this Association in order properly to inculcate within the membership and the industry that professional spirit which the great majority of the industry wishes to promote.

From a statistical standpoint, the results of the Association's examination program are as follows: It has been found necessary to take disciplinary action against approximately 5% of the membership of the Association; in all, 170 complaints have been filed since January 1, 1941. Of these, 99 involved violations of our Rule which provides that members shall deal fairly with their customers in the purchase and sale of securities. Thus, as a result of a concerted, well-organized effort on the part of the Association to root out such bad practices within the membership as do exist, the Association has found it necessary to file complaints against approximately 2.6% of its membership where the matters concerned involved allegations of dealing unfairly with customers in the purchase and sale of securities, which, of

course, includes the matter of dealers' buying or selling securities at prices not reasonably related to the market.

Our knowledge of the practical nature of this matter does not end with this report of what our program has disclosed to be the size of the problem and the steps taken to solve it. The Association has prepared a detailed analysis of profit policies of practically all members. It knows the number and the location of members whose policies are in need of policing. Their number is small in relation to the total of our membership but the important fact is that we know who they are and where they are and we have already demonstrated our capacity to deal with them. We are not winking at abuses and we do not deny that a minority in the business perpetrate them, but we repeat: we know who they are and where they are.

We are not wholly satisfied with our examining processes, effective as they have been to date. As the Commission has been notified previously, examination of each member at least once a year is our program for the future. We have developed a plan to improve upon investigations into members' business practices which will bring to light information upon which the Association can move promptly against all types of improper acts and practices.

We are, as always, prepared to discuss these matters in detail with the Commission.

Representatives of the staff of the Commission have stated this proposed Rule to be the result of an increasing awareness of a practice growing in the over-the-counter market for dealers to buy from or sell to their customers at prices bearing no reasonable relationship to the market. It has further been said by representatives of the staff that this practice has been indulged in by many over-the-counter brokers and dealers. These statements of purpose, in our opinion, constitute an indictment and cast a reflection on the entire industry, which we do not believe to be either true or warranted by the facts. It has been the Association's experience that there is a group in the industry which engages in practices not consistent with good business ethics. The Association and the membership are presently and have been in the past engaged in a sincere endeavor to eradicate and to eliminate from the industry the practices of this group, not only in the interest of the public, but also in the selfish interest of the business itself. The previous statement of the examination work of the Association substantiates the opinion that only a small group in the business has been transgressing the bounds of good business ethics in respect to their sales and profit policies in the business transactions.

The staff of the Commission has further stated that this alleged practice which motivated this proposed Rule is a growing practice and that the Rule is to protect investors who are frequently charged prices for securities which bear no reasonable relationship to the existing markets. We submit that the Association cannot but conclude, because of our own experience and information in their field, that the record does not bear out these contentions and statements of the Commission's staff that the alleged practice is either *a practice within* the industry, that it is *an increasing practice*, or that investors are *frequently* charged prices bearing no reasonable relationship to the market. We further submit that those few who are in the marginal element of the industry constitute a small and diminishing minority; that this proposed Rule may very well harm the present trend of investigation and examination work within the industry being done by the Association and the Commission; and completely disorganize the work which is presently being done to promote high standards of business and commercial ethics within this business. Authorities who have had experience in this field fortify us in our opinion that rules such as this proposal are not self-enforcing and, in and of themselves, will not eradicate bad ethical practices. These authorities further say that no rule is as effective as correction and enforcement through examination work.

The Executive Committee, in the foregoing statement, has attempted to demonstrate that the objectives of the Association and the Commission can best be attained by a continuation of the coöperative work by the Association and the Commission in an en-

deavor to advance and enforce high standards of commercial honor and integrity, just and equitable principles of trade, and business ethics. We are of the certain opinion that the Association can demonstrate to the Commission, to the industry, and to the public that the public interest, the interest of the Commission, and the selfish interest of the industry at large can better be served by this coöperative effort than by a rule which, in our considered opinion, is unnecessary and which will take from the Commission as well as the Association many of the tools so effectively used to date.

The members of the staff of the Commission do *not* claim that the membership of this Association has *not* been adequately policed, nor that the problem the staff is endeavoring to solve is one which is a prevalent practice within the membership of the Association. It has been suggested that this Association is the proper vehicle for the solution of such problem as does exist. The staff of the Commission, in answer to this suggestion, has stated that there is a primary objection to this suggested solution, inasmuch as there are a great many registered brokers and dealers who are not members of the Association and who are undoubtedly guilty of the practice of over-pricing and who would be able to operate without supervision comparable to that of the Association during any period of experimentation with this suggested solution.

The Association has made a spot check of the list of registered brokers and dealers who are not members of this Association and who are not members of Stock Exchanges to determine whether, in fact, these non-members registered with the Commission are actually engaged in the securities or investment banking business. Our inquiries disclose that a very large proportion of these non-members actually are not engaged in the securities business. We have ascertained that many of those registered with the Commission are registered only incidentally to other activities and are not, in fact, engaged in the securities business; many still registered are now deceased; many have left the business for innumerable reasons and have merely neglected to withdraw their registrations.

In conclusion, the position of the Executive Committee in this statement is as follows:

(1) Association experience has demonstrated that only a small marginal element within the business has engaged in the practices which the proposed Rule would seek to cure;

(2) the purposes of the Association and the Commission can best be served in the interests of all concerned by further coöperative effort;

(3) the Association will demonstrate that the problem can be met most effectively in the interest of the public and the business by continuing our coöperative work in an atmosphere of mutual confidence;

(4) to put such a rule into effect would undoubtedly harm a large portion of the business and not reach those at whom the proposed Rule is directed, it being our considered opinion that the proposed Rule, if promulgated, would be easy to evade;

(5) the number of registered brokers and dealers outside of the Association is not large enough nor is their volume of business important enough to justify such a rule on the grounds that they are beyond N.A.S.D. policing and therefore constitute a major problem for the Commission; and

(6) there would be no further need for the Association in the field of work in which it has been most active and successful.

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