MEMORANDUM ON SELLING PRACTICES OF THE AMERICAN SECURITIES INDUSTRY

A Proposal of Policy

and

An Analysis of Related Recommendations in the SEC Special Study

Ad Hoc Committee

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FOREWORD

The Report of the Special Study of Securities Markets of the Securities and Exchange Commission raises important questions concerning, among others, "selling practices" of the securities industry. The purpose of the Special Study Report has been described as an attempt to raise the entire securities industry to the best standards which the industry itself proclaims. The Commission has asked the industry to develop preliminary suggestions as to the form and the extent of new rules or guides which will achieve this end and thus we are in a position to work constructively with government in the development of the policies and rules under which we are to do business.

A small ad hoc committee has been appointed to study and to analyze various recommendations in the Special Study Report that deal with "selling practices" and to make a proposal of policy to be considered by the industry. This committee is made up of men whose firms do business in all parts of the country, and are active in most of the areas of the business—listed markets, over-the-counter markets, underwriting and mutual funds.

It is not the function of this committee or the purpose of this memorandum to attempt to speak or set policy for the Investment Bankers Association of America or for the industry in general, but wise policy can only be developed after men qualified by training and experience in each area of the business and each part of the country have focused on the problems involved. The securities industry performs a vital function in this country and it is a matter of important public interest that the economic operating unit of this business—the securities firm itself—actively participate in the advance planning for the policies and rules which are to govern its operations.

Therefore, it is hoped that this memorandum will (i) focus the attention of the industry on the problems involved in future rules or guides on "selling practices" to be adopted by the SEC and the self-regulatory agencies; (ii) develop criticisms and suggestions from securities firms—before the ideas of either business or government become too rigid; and (iii) help us to achieve that goal which we in the industry so heartily endorse, of spreading widely the high standards existing within our industry.

AMYAS AMES, *President*
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December 2, 1963

SUMMARY OF CONCLUSIONS

In this memorandum we analyze those recommendations in the Special Study Report which we understand the Commission to regard as of high priority in the area of selling practices. We have also included recommendations of the Special Study regarding minimum capital requirements and qualifications to enter the industry. Although not within the immediate area of selling practices, we believe that proper standards of financial capacity and responsibility, together with adequate supervision of competent personnel, will be by far the most effective methods of eliminating improper selling activities.

While this memorandum is only a preliminary effort, it leads us to propose means by which our industry can work with the regulatory and self-regulatory authorities to achieve a common good.

Recommendations We Support

The Special Study Report was the result of a thorough study of the industry over a two-year period. Many of its recommendations evidence understanding and appreciation of our business and its problems, and we approve them. For example:

(1) We concur that the individual should receive more attention as an appropriate unit for regulatory purposes. The standards of an industry can only be effectively raised by improving the quality and the performance of the people who work in it.

(2) We agree that standards for entry and continuance in the business should be developed and administered by the self-regulatory authorities, and that they should encompass competence of personnel (in the sense of knowledge tested through examinations and appropriate experience) as well as financial capacity and responsibility of firms.

(3) We also agree that training and supervision of sales personnel should be emphasized anew, and that the supervisory methods employed should be improved wherever possible.

(4) We believe that more effective self-regulation can be devised for certain selling practices, including market letters, advertisements and other sales literature. We also think that more

specific standards should be considered by the NASD with respect to ''mark-ups'' in the over-the-counter markets, and that the dissemination of retail quotations in those markets can be improved.

(5) We support all appropriate steps to stamp out ''boiler shop'' activities.

Recommendations with respect to subjects such as these can and should be carried out on an industry-wide basis.

Recommendations We Disapprove

The more other recommendations are analyzed, the clearer it becomes that in the course of the Special Study either the problems were not clearly understood or the practical aspects were not given due weight in the formulation of the solutions recommended. To illustrate:

(1) We oppose regulation or self-regulation which would encroach upon prerogatives of responsible management, restrict branch office managers' legitimate sales activities, interfere with management's right to determine what and how employees are paid, or dictate data processing techniques.

(2) While we agree that securities salesmen should be highly qualified to perform their function, we deny that they are or should be responsible for the ''suitability'' of the purchases their customers make. Adoption of specific ''suitability'' regulations could so restrict the industry as to preclude performance of its essential function in the American economy.

(3) We deny that abuses can be eliminated by pyramiding regulation and self-regulation, such as, specifically, requirements for marking all orders ''solicited'' or ''unsolicited'', for having all customers' cards show investment goals, or for inserting market data in over-the-counter confirmations. Also, we do not believe that improper practices can be eliminated by detailed regulations premised upon the use of mechanical techniques such as initials on documents, names in files, long bibliographies, specific rather than general hedge clauses, and tidy filing of underlying information.

(4) We consider unsound any procedures designed to introduce artificial ''deflation'' in the after-markets for so-called ''hot'' first issues, and we oppose the introduction of untried, theoretical

procedures designed to revolutionize the over-the-counter markets such as making "wholesalers" into "primary market makers" for the retail markets.

(5) We condemn investigation and enforcement devices which are novel, theoretical and foreign to our system.

Recommendations such as these encroach unnecessarily on the rights of management and should not be pursued. Their implementation can only result in more harm than good. The objectives of both government and industry can best be realized without resort thereto.

A Proposal for Industry Policy

FIRST: *Support the SEC sponsored legislation now before Congress.* The proposed legislation will provide the basis for the additional regulation and self-regulation which the industry should endorse, thereby enabling the regulatory and self-regulatory agencies to establish and administer effective industry standards. It will also enlarge significantly the volume of available information about issuers of corporate securities.

SECOND: *Urge statesmanship in the SEC's implementation of its recommendations.* The SEC should proceed without haste, with due attention to and regard for practical effects and consequences and with readiness from the outset to consult fully and freely with responsible representatives of the industry.

THIRD: *Urge similar precepts for the self-regulatory agencies.* The NASD and the stock exchanges also should consult in advance with their membership generally before adopting rules or other guidelines relating to practice or conduct in the industry.

FOURTH: *Participate constructively with the SEC and the self-regulatory agencies.* At all stages of the administrative processes, however preliminary, industry representatives should offer their practical advice and assistance, and provide constructive comment and suggestions where the principles are sound, concessions where appropriate,

and firm opposition where necessary. To this end, individual firms should contribute the time of their best people.

Fifth: *Encourage the SEC and the self-regulatory agencies to reduce and eliminate duplication.* The start which has been made in the unification of tests for competence and of the work of special investigations should be continued and extended. Elimination of duplication by the SEC, the NASD, the stock exchanges and the state commissioners is essential, especially if there is to be any additional regulation, and uniformity must be the keynote. Multiplicity in administration or investigation is costly, time consuming and unreasonable.

ANALYSIS OF SELLING PRACTICE RECOMMENDATIONS

The following are the selling practice recommendations which are analyzed in this memorandum:

	House Document No. 95
Chapter II F.4-8 and 10-12—"Qualifications for Persons in the Industry"	Pt. 1, p. 160-1-2
Chapter III B.1—"Supervision of Selling Activities"	Pt. 1, p. 328
Chapter III B.2—"Surveillance and Enforcement Procedures"	Pt. 1, p. 328
Chapter III B.3—"Certain Selling Practices"	Pt. 1, p. 329
Chapter III B.4—"Suitability"	Pt. 1, p. 329
Chapter III B.5—"Official Data"	Pt. 1, p. 329
Chapter III B.6—"Compensation of Salesmen"	Pt. 1, p. 329-30
Chapter III C.1—"Research and Advisory Services"	Pt. 1, p. 386
Chapter III C.2—"Investment Advice"	Pt. 1, p. 386-7
Chapter III C.3—"Market Letter Surveillance"	Pt. 1, p. 387
Chapter III C.4—"Reckless Investment Advice"	Pt. 1, p. 387
Chapter III C.5—"Organization of Investment Advisers"	Pt. 1, p. 387
Chapter IV B.1—"First-hot Issues"	Pt. 1, p. 557
Chapter IV B.2—"First Issue Rules"	Pt. 1, p. 557-8
Chapter IV B.3—"Acceleration of First Issues"	Pt. 1, p. 558
Chapter IV B.4—"Prospectus Deliveries"	Pt. 1, p. 558
Chapter IV B.5—"Free-riding and Withholding"	Pt. 1, p. 558-9
Chapter IV B.8—"Rule 10b-6"	Pt. 1, p. 559
Chapter VII F.13 (a) and (c)—"Disclosures in Certain Retail Transactions"	Pt. 2, p. 677-8

In order that this memorandum may be a self-contained document we have set forth in italics prior to our analysis the full text of the Special Study recommendation. Since Chapter II F.4-8 and 10-12 contains recommendations that, to a large extent, are the subject of the legislation introduced in the Congress on June 4th, we thought it preferable to comment on these latter recommendations at the end, rather than at the beginning, of this section of the memorandum.

CHAPTER III B. 1
("Supervision of Selling Activities")

The Special Study concludes and recommends:

1. The supervision by broker-dealers of the selling activities of their personnel, particularly in branch offices, should be generally strengthened by the adoption of appropriate procedures including, but not necessarily limited to: the designation of one home office senior

executive responsible for internal supervision and regulatory and self-regulatory matters generally; increasing the branch manager's supervisory role while deemphasizing his selling activities in branches having large numbers of salesmen; and in large firms with many branches, the tightening of home office control procedures, with more extensive use of electronic data processing equipment programmed to expose overtrading, undue concentration in speculative securities, and other potential abuses.

We agree that the supervision by each broker-dealer of the selling activities of its personnel should be adequate to permit the conduct of its business in accordance with just and equitable principles of trade and in compliance with applicable statutes and regulations. Whether and to what extent further action in this area by any particular broker-dealer is required depends upon the procedures which it is already following. Also, the appropriateness of the procedures followed by any particular firm depends upon a wide variety of factors, such as the number, character and training of its personnel, its size, the number of its offices, and the nature of its activities and of its clientele. The proper procedures for any particular firm is a matter of managerial responsibility.

We do not believe that it is the function of the Commission or the self-regulatory agencies to specify, by regulations of general application, specific procedures for supervision which must be followed by all the many diverse firms in the industry. The release by the Commission and self-regulatory agencies from time to time of information showing the efficacy of particular procedures might, however, be of significant help to members of the industry. The self-regulatory agencies (in a fashion which will avoid duplication) should provide member firms with better-organized and more effective material for the development on a voluntary basis of internal operating and supervisory procedures. Some firms have found that an internally prepared operating manual is very useful, and model manuals might perhaps be developed which firms could modify to meet their own particular requirements.

For a number of reasons (including the Report of the Special Study) the respective members of the industry who have high standards are well aware of the problems in the area of supervision and have

developed and are continuing to develop appropriate procedures. The existing rules of the Commission and the self-regulatory agencies are sufficient to permit appropriate action against the other members.

We consider entirely impractical any regulation which would restrict branch office managers from legitimate sales activities or which would require the use of electronic data processing equipment.

Chapter III B. 2
("Surveillance and Enforcement Procedures")

The Special Study concludes and recommends:

2. The self-regulatory agencies should establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision by their member firms. While the recent publication of the New York Stock Exchange's guide to supervision and management of registered representatives and customer accounts represents a significant step in this direction, the implementation of the standards there set forth will call for strengthening of surveillance. The NASD control procedures in respect of selling practices are also in need of substantial strengthening. More regular and frequent examinations of branch offices are called for, and examinations should include interviewing salesmen and in appropriate cases customers, when accounts show heavy trading or concentration in speculative issues.

To the extent practical and economic, we endorse the concept that "self-regulatory agencies should establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision".

As the Special Study recognizes, the principal focal point in this area is the salesman who has direct contact with the customer. It is obviously impractical for either the broker-dealer or the regulatory or self-regulatory agencies to examine every action by every salesman and consequently the most productive approach would seem to be to improve the standards of the salesmen. Steps already taken and those in contemplation should do much to correct abuses which may have existed in the area of selling practices.

Care must be taken, however, in adopting stronger procedures for detection and enforcement to avoid unnecessary duplication of activity. For example, even under present procedures, in one case involving the conduct of two employees of a broker-dealer which resulted in civil litigation for a relatively small amount of money, there are at least 24 persons (including lawyers, investigators and executives from the NASD, two state commissions, two securities exchanges, an insurance company and the broker-dealer) devoting a significant amount of their time to the investigation. We urge that any steps taken in this area be designed not only to improve the effectiveness of detection and enforcement facilities but also to eliminate much of the duplication of activity by the regulatory and self-regulatory agencies that already exist.

The effectiveness of expanded detection and enforcement machinery, particularly in relation to selling practices, must be weighed against the cost of such expansion. A substantial increase in the number and comprehensiveness of examinations by the regulatory and the self-regulatory agencies, additional manpower, and the diversion of personnel from their present supervisory functions to participate in such examinations might well result in excessive costs. Consequently, careful consideration should be given to synchronizing such examinations by the regulatory and the self-regulatory agencies so as to avoid unnecessary duplication and thus permit more effective examination of a greater number of broker-dealers with less increase in expensive manpower.

CHAPTER III B. 3
("Certain Selling Practices")

The Special Study concludes and recommends:

3. The Commission should adopt rules to facilitate and reinforce controls by firms, the self-regulatory bodies and the Commission over selling practices. Such rules should, for example, require: that every retail transaction be designated "solicited" or "unsolicited" in the permanent records of a broker-dealer; that all customer complaints be

kept in a single file and available for inspection and examination by the Commission, the NASD, and the exchanges; and that customer account cards or similar records include such information as investment goals, occupation and type of service desired.

These recommendations involve such diversity that we will discuss them under separate headings.

Solicited or Unsolicited

A number of firms have their own practices regarding the marking of retail transactions as "solicited" or "unsolicited". In some cases all such transactions are involved, in others only underwritings or other particular types, and in still others only certain securities. Basic to all is the belief that a record of whether a transaction is "solicited" or "unsolicited" may prove useful for business or legal reasons.

There is a wide gulf, however, between a voluntary practice and an SEC rule having the force of law. A practice can be adjusted at will to accord with developing circumstances and excusable omissions can be forgiven. An administrative rule would be rigid and difficult to amend and enforce, and any infraction could entail criminal and civil liabilities as well as disciplinary action.

A busy securities man in the course of an active day cannot be expected to solve the dilemma of "solicited" vs. "unsolicited",—an area where even lawyers flounder. Obviously there are many clear cases of orders that are unsolicited. The size of the field for doubt, however, is enormous.

We are satisfied that a workable general rule is not a practical possibility and that any policy of marking transactions "solicited" or "unsolicited" should remain a matter of management discretion.

Customer Complaint Files

An SEC rule requiring all customers' complaints to be placed in one file would be unnecessary and undesirable.

The SEC, the NASD, the stock exchanges and State authorities can get at the complaints wherever they are. Everyone in the industry

already is required to keep customer complaints on file, and they are available to anyone with authority to see them.

In keeping with good management, correspondence of this as well as other types usually will be in the individual customers' files. To order that copies be lodged in another file would go too far. There would be the problem of deciding what are or are not "complaints" for this purpose. Sometimes it is difficult to distinguish between inquiry and complaint, and certainly plain "beefs" should not be included. Also, what of the "complaint" which is answered fully and to the satisfaction of the customer in a single reply?

Customers with legitimate complaints have many adequate ways to pursue them. If their complaints are not handled in what appears to them to be a satisfactory manner, they can go to the stock exchange, the NASD, the SEC, State authorities, or place the matter in the hands of counsel for civil action. Under our system, there need be no more.

Investment Goals

Some firms in the business use records which purport to show investment goals and type of service desired. Many equally conscientious firms, after consideration, do not. This is again something which should be left to the discretion of the particular firm; it is not a subject for a rule with the force of law.

Many customers simply would not furnish the information. Others would furnish it in such broad or ambiguous form that it would serve no useful purpose. Still others, and this might be the largest segment, would not admit, or would be unable to express, what they really have in mind. Few investors, no matter what their intention, would be willing to identify themselves on the record as "speculators".

Investment goals change; and no firm could, as a practical matter, comply with a rule requiring it to keep records abreast with the changing subjective attitudes of its individual customers.

CHAPTER III B. 4
("Suitability")

The Special Study concludes and recommends:

4. Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of "suitability" of particular se-

curities for particular customers. The NASD, which has taken leadership in this respect by adopting a general suitability rule, should provide further definition of content and more effective surveillance and enforcement. The NYSE, which has less clearly recognized suitability as a standard of conduct, should make greater efforts to define its content and undertake necessary surveillance and enforcement. This area would seem to be a particularly appropriate one to be dealt with through Statements of Policy (similar to that now applicable to investment company selling literature), which can provide the necessary balance between generality and specificity of standards. Such Statements of Policy should cover such matters as: possible guidelines as to categories or amounts of securities deemed clearly unsuitable in specified circumstances; practices deemed incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to other than known customers; and approved and disapproved practices in the handling of discretionary accounts.

The Special Study notes that the NASD has taken leadership in the "suitability" area by adoption of Article III, Section 2, of the Rules of Fair Practice:

> "*Section 2* In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

Of all the problems noted in the Special Study, "suitability" may well be the most difficult. All are agreed upon the necessity to rid the industry of those at its fringe who practice "boiler room" tactics, but in cutting out this cancer the utmost in surgical skill is required lest the patient be maimed.

All are agreed further that not every security is appropriate for every customer. We deal in our business with an infinite variety of securities and an infinite variety of customers. In a sense, the function of the salesman is to help match the right customer with the right security at the right time. We should not adopt a "cure" for the

"suitability" problem which shackles the salesman's ability to perform that function.

Presumably it was for reasons such as this that the Special Study does not recommend new regulation by the SEC in the "suitability" area. The SEC armory is already well stocked and there can be little doubt that the SEC, armed with the weapons already at hand, can drive out of business any "boiler room" and any firm or individual taking unfair advantage of customers.

Rather than SEC regulation, the SEC proposes:

> "This area would seem to be a particularly appropriate one to be dealt with through Statements of Policy (similar to that now applicable to investment company selling literature), which can provide the necessary balance between generality and specificity of standards. * * *."

For the very same reasons that the Special Study did not recommend SEC regulation with respect to "suitability", we do not believe that specific "guidelines as to categories or amounts of securities" can be formulated. A balance between "generality" and "specificity" is more than a matter of delicacy. "Specificity" necessarily involves prediction of the future, and who in 1925 would have challenged the "obvious fact" that railroad common stocks were "investment grade" stocks? The wide ranging differences between securities,—both over the short term and the long term,—and the significant differences as among customers make "specificity" impossible.

We now have generality, and anything more specific could have crippling side effects. It does not follow, however, that the industry should pursue a course of inaction in the suitability area. Much has been done already and more can be done. The problem deserves continued thoughtful analysis in the light of industry experience.

Analysis of the problem necessarily begins with the salesman, for he is the point of contact with the customer and he is ordinarily the person within the firm who best knows the customer. The limited role of the salesman must be recognized. He need not and should not be regarded as a professional who can be expected in every case to ad-

minister generally to the financial needs of his customer, as the physician does to his patient.

The salesman may be a mere conduit for the execution of unsolicited transactions, in which case he plays no part in the selection of the securities to be bought or sold. At the other extreme, he may be the holder of broad discretionary authority with respect to the customer's entire account. Then he is truly an investment counselor with responsibilities under existing law in some respects not unlike those of a fiduciary. Between the extremes there is infinite variety, but, generally speaking, the salesman's role is determined by the extent to which his recommendations are requested by the customer.

Perhaps the present NASD Rule of Fair Practice should be studied to see whether it can be redrafted and refined in a practical manner to sharpen its focus upon the salesman as the point of contact with the customer and to reflect the varying role of the salesman in varying circumstances. Basically, the solution is in personnel standards,—both at the salesman and at the supervisory levels.

CHAPTER III B. 5

("Official Data")

The Special Study concludes and recommends:

The importance of disclosure for the protection of investors has long been recognized in securities regulation, and it is of particular value in connection with selling practices. The present mandatory, officially filed disclosures by issuers (reports and proxy statements), extended and improved as recommended in Chapter IX, should have wider and more prominent use in selling activities, and the obligations of broker-dealers in this regard should be appropriately defined by the self-regulatory agencies and the Commission. These obligations might include such matters as: actually consulting available officially filed data prior to recommending or selling specific securities; furnishing copies to customers in appropriate cases; and advising customers whether officially filed information is available with respect to any security recommended for purchase.

Full and fair disclosure is the cornerstone of our securities distribution system. If these recommendations would contribute to that significantly and on a practical basis, they should have our wholehearted support. Unfortunately, the obligations they contemplate would not meet either test.

The officially filed reports mentioned are principally Forms 10K and 8K and proxy statements. Form 10K is a periodic report called for once a year and furnishes a brief running account of some management affairs and contains detailed financial statements and schedules. Form 8K is a current report required to cover non-routine developments shortly after their occurrence. Proxy statements are required to inform stockholders in advance concerning matters to be acted upon at their meetings. Proxy statements serve well their intended purpose but (except for the limited number which relate to mergers or other non-routine corporate activities) their value for investment disclosure purposes escapes us.

The reports are filed and are matters of public record at the SEC in Washington and at the stock exchanges on which the particular securities are listed. Anyone wishing to study them must either visit one of those places, or obtain photostatic copies from the SEC at a cost of either 23¢ per page or 11¢ per page (where 8½″ by 14″ or less), and with a time lag which even now is from 3 to 8 days. We would guess that very few 10K reports would cost less than $5, that many would cost much more, and that proxy statements for mergers would involve comparable costs. Proxy statements go to all the stockholders of the particular corporation, but are obtainable by others only at the SEC or the stock exchanges.

We recognize fully the responsibilities the industry has with respect to the accuracy and completeness of information used in selling activities. The means available for obtaining and checking the necessary data are many. Official documents are only one of them and they are not the only sources even for the information they contain. Others include annual and interim reports published by the corporations themselves, statistical services, discussions with company officials and others in the same industry, trade and governmental publications, and press

reports. Any important information in an officially filed report will invariably be picked up by the financial services and reprinted or abstracted in current statistical publications. The industry does not need to be told what sources to use. It is competent to select among them and it uses the official data when and to the extent appropriate and practical.

The first two recommendations appear to contemplate regulation by the SEC or self-regulatory bodies requiring that officially filed data be consulted prior to recommending or selling specific securities, and that copies of such data be furnished to customers. Such a regulation would not have to go very far before it would fall by its own weight. Perhaps large firms in the principal metropolitan areas could comply, but even that becomes doubtful when time and expense are considered. Other firms throughout the country could not begin to comply. Finally, the SEC and the stock exchanges themselves would have budgetary problems meeting demands for photostating and public record inspection far beyond their present capacities. Clearly, these practical objections outweigh any theoretical benefit which might be expected.

The third recommendation would call for advice to customers whether officially filed information is available with respect to securities recommended for purchase. Here, too, something would depend on scope. Certainly no one could dream of attempting to require every salesman every time he talks to a customer to tell the customer whether or not something is on file in Washington. Even if he did, what possible value would it be to the ordinary customer?

These recommendations may have theoretical appeal, but on analysis they fail completely to meet the tests of practicality and utility.

Chapter III B. 6

("Compensation of Salesmen")

The Special Study concludes and recommends:

6. The almost universal industry practice of compensating salesmen in proportion to the volume of business produced may be assumed to be inherent in the nature of the business, but certain of its particular

aspects may tend to introduce undue pressures or biases into the selling process. This would appear to be another appropriate area for continuing attention of the self-regulatory agencies, with the view to evolving rules and standards, in line with the best existing practices, that might eliminate or reduce the more extreme forms of pressure or bias in selling. Among possible measures in this direction that should be considered by broker-dealer firms and the self-regulatory agencies would be: making monthly compensation less specifically dependent on each month's production; eliminating a step-up of commission rates for transactions in a given month on reaching a stated volume for the month; discouraging undue compensation differentials for sales of different categories of securities where advisory bias may result from the compensation differential; and requiring disclosure of extra compensation in respect of particular types of transactions.

We agree that it is appropriate for each broker-dealer to review its compensation practices to eliminate (if they exist) any "extreme forms of pressure or bias in selling".

We strongly oppose, however, any procedure which will bring the self-regulatory agencies into the area of compensation of personnel. This is a matter which should be the responsibility of management in this industry. In fact, we know of no industry (whether or not regulated) in which it is not such a responsibility. It is unrealistic to attempt to bring about by regulation the elimination of higher compensation for effective production or where more selling effort is required. This practice is accepted throughout American business and has been responsible for the development of many industries which make important contributions to our economy.

We consider that a required disclosure to customers that part of the compensation paid to a firm which is then allocated to its personnel (whether "extra" or otherwise) would be unwarranted and of no benefit to customers.

Chapter III C. 1

("Research and Advisory Services")

The Special Study concludes and recommends:

1. Investment advice furnished by broker-dealers, though an integral part of their business of merchandising securities, is incidental

to that business and, for the small investor particularly, their facilities for providing advice are quite varied in quantity and quality. This being the case, a minimum protection for such investors is that firms should not be permitted to represent that they perform research or advisory services which they are not reasonably equipped to perform. The New York Stock Exchange, instead of indiscriminately encouraging its members to advertise their research and advisory facilities, should adopt standards governing the representations its members may make in this regard, and the NASD should provide similarly for its membership.

The necessity for supplying information about securities to investors and potential investors has long been recognized by members of our industry and the quality of the information which is supplied to the investing public by our members is generally good. The study points out, however, that in a few cases there have been firms whose advertisements have promised more than the organization was able to supply. We believe that such practices are reprehensible and, in general, we favor the recommendation that our self-regulatory organizations have rules prohibiting false or misleading claims regarding research or advisory services.

CHAPTER III C. 2

("Investment Advice")

The Special Study concludes and recommends:

2. Specific practices with respect to investment advice, whether expressed in market letters, advertisements or otherwise, should receive more positive and effective attention from the self-regulatory agencies. Such agencies obviously cannot assume responsibility for the staffing of their member firms or the quality or validity of specific recommendations, but they should assume responsibility for eliminating irresponsible or deceptive practices by their member firms. This area also lends itself to establishment of standards through statements of policy, covering such matters as (a) required disclosures in printed material of sources of information, research techniques used, and/or other bases of recommendation, rather than general disclaimers as to sources and

reliability of data in market letters; (b) required disclosures in written advice of existing positions, intended dispositions, and market-making activities, rather than general "hedge" clauses as to possible present conflicting positions or transactions; (c) required indication of the name of the person responsible for the preparation of market letters, and dating of such materials; (d) in printed investment advice which purports to analyze issuers, required references to most recently filed official disclosures by issuers, and representations that such filed information has been examined, with specific identification of issuers for which no officially filed information is available; (e) prohibition of specific practices in connection with written or oral recommendations, such as predicting specific future price levels of particular securities, claiming "inside" information by reason of a directorship, and trading against recommendations or other self-dealing; and (f) required disclaimers in connection with salesmen's written or oral recommendations not emanating from a firm's research department or otherwise sponsored by the firm.

Many of the suggestions in this recommendation are too extensive for general use in the industry or are unnecessarily burdensome. For example, the techniques of modern securities research are constantly changing. The use of electronic machinery, the increasing amount of information available to analysts, the subjective reactions of the authors, new concepts, etc., make it nearly impossible to describe all of the techniques used in preparing a particular piece of research material. Yet item (a) would require this.

Under item (b) a dealer would always be faced with the practical question of at what instant of time does he disclose his position and for how long does he abide by his written intended disposition of a position, regardless of market action.

Item (c) gives unnecessary publicity to a single person in an organization when, in fact, in many organizations the communication may be the work of many people rather than just one person. The firm issuing the letter is and should be responsible for its contents.

Item (d) involves "recently filed official disclosures". We have already commented on the use and efficacy of these disclosures.

Item (e) involves practices which we thought had long been proscribed by the general "anti-fraud" provisions of federal and state securities statutes and regulations.

Item (f) could well be a boon to the casual, disingenuous salesman who would skillfully interject a specific hedge clause into each letter and telephone conversation, and a trap for the well-trained analyst seriously concerned with research and evaluation but forgetful of the niceties of "required disclaimers".

We feel that this entire recommendation does not meet the practical touchstone of sensible practice, and that proper policing of general regulations would better accomplish the desired end.

CHAPTER III C. 3
("Market Letter Surveillance")

The Special Study concludes and recommends:

3. The market letter surveillance program of the New York Stock Exchange should be strengthened and redirected toward achieving greater responsibility and restraint in the use and contents of such letters. More effective market letter surveillance should also be undertaken by the NASD and the other exchanges, or a coordinated program of self-regulatory agencies should be evolved.

We agree that market letters should reflect responsibility and restraint and should be subjected to effective surveillance by the self-regulatory agencies.

Surveillance should be handled through an intelligent, coordinated program, and the letters of each broker-dealer should be handled by one agency without duplication. This would also tend to keep regulatory costs within reasonable limits. Obviously every communication to the public issued by a broker-dealer cannot be reviewed by a self-regulatory agency. Intelligent coordinated programs must necessarily rely extensively on test checking on a selective basis.

Chapter III C. 4

("Reckless Investment Advice")

The Special Study concludes and recommends:

4. Reckless dissemination of written investment advice by broker-dealers, whether or not for a separate fee, or by registered investment advisers, should be expressly prohibited by statute or by rules of the Commission and the self-regulatory agencies and should be made expressly subject to civil liability in favor of customers reasonably relying thereon to their detriment. Without limiting the general principle, written investment advice which purports to analyze issuers but fails to consider most recently filed official disclosures of issuers should be one of the factors to be considered in determining whether such advice is recklessly disseminated.

Reckless dissemination of "misleading" written investment advice should obviously be prohibited; and existing statutes and regulations do provide civil remedies to customers who rely thereon to their detriment. But let us not try to define terms to mean what is not generally comprehended by them. "Reckless", "dissemination", "reasonably relying" must mean what they say to the layman so that he can conduct his business on a day to day basis. It is not the "dissemination" which causes the problem, but rather the content of the "written investment advice".

We have already commented upon the use and efficacy of "recently filed official disclosures".

Chapter III C. 5

("Organization of Investment Advisers")

The Special Study concludes and recommends:

5. As recommended in Chapter II, registered investment advisers other than broker-dealers, should be organized into an official self-regulatory association or associations, which should then adopt and enforce substantive rules corresponding to those recommended above

in respect of advisory activities by broker-dealers. Alternatively, the Commission should extend and strengthen its own direct regulation of advisers to accomplish the purposes indicated.

We do not object to an association of investment advisers so long as membership is not required of those who are members of the NASD. Otherwise, there would be an unjustified pyramiding of cost for NASD members.

CHAPTER IV B. 1

("First-hot Issues")

The Special Study concludes and recommends:

1. The Commission's administration of the registration provisions and related exemption provisions of the Securities Act has been one of its most outstanding achievements, and the statute itself has proved generally adequate and workable. Nevertheless, there are limited respects in which provisions of that statute and the administration thereof or of related provisions of the Exchange Act should be modified in order to adapt them more closely to experienced needs. The troublesome and sometimes dangerous phenomenon of "hot" issues is primarily associated with "first" issues, i.e., first public offerings of securities of a particular issuer. Accordingly, such "first" issues, whether fully registered or exempt under Regulation A, should receive particular attention, with a view to preventing certain practices that appear to have contributed unnecessarily to "hotness," while not interfering with normal and legitimate practices in connection with underwriting of "first" or any other issues or the flow of venture capital into new business.

We would endorse any procedure which would eliminate any practices which contribute unnecessarily or artifically to "hotness" and would not interfere with normal practices in connection with the distribution of securities to the public for the first time. As noted below, for the most part the specific Special Study suggestions do not meet this test.

Chapter IV. B. 2

("First Issue Rules")

The Special Study concludes and recommends:

2. Appropriate rules should be adopted by the NASD and/or the Commission, applicable to "first" issues of common stock generally, designed to eliminate or temper certain factors which, either independently or in interaction with each other, appear to have produced artificially high but ephemeral premiums in many instances. Among the types of rules that would appear appropriate for consideration and adoption would be rules (a) requiring that, with respect to allotments resulting from solicitations or indications of interest prior to the effective date, notices of allotment (in the form of confirmations or otherwise) be given to purchasers as promptly as reasonably possible, any delay of more than (say) 24 hours after the effective date to be deemed prima facie unreasonable; (b) requiring that, again with respect to allotments resulting from solicitations or indications of interest prior to the effective date, certificates of stock be delivered or made available for delivery to purchasers as promptly as reasonably possible, any delay of more than (say) two weeks after the effective date or more than (say) one week after the underwriting closing to be deemed prima facie unreasonable; (c) prohibiting all broker-dealers from initiating a trading market for a limited period of (say) 72 hours after the effective date, except for stabilizing activities in conformance with Rule 10b-7 and such other exceptions as may be provided by rule or in specific circumstances; (d) clarifying or defining restrictions on soliciting, holding or transmitting, prior to the effective date, indications of interest or orders to purchase in the open market after the effective date; and (e) prohibiting all participants in the public offering, until the distribution is completed or for a period of (say) 40 days after the effective date, whichever is later, from soliciting or recommending purchases of the stock (including placing stock in discretionary accounts) at a price in excess of (say) 120% of the public offering price.

We would presume that any new regulation in this area would differentiate between the types of issuers coming to market for the

first time, and also would be restricted exclusively to common stocks and securities convertible into common stock.

These recommendations involve such diversity that they are discussed under separate sections. Sections (c), (d) and (e) do have in common, however, the concept of creating artificial ''deflation'' in the after markets of new issues.

(a) *Notices of allotment (in the form of confirmations or otherwise) be given to purchasers as promptly as reasonably possible.*

We would support a rule which would require that written confirmations of sales resulting from solicitations or indications of interest prior to the effective date be sent or given as soon as reasonably possible under the circumstances. We assume, however, that any such rule or any rule adopted in accordance with section (b) below would be considered in the light of already existing rules relating to confirmations and deliveries which are to be found in the Uniform Practice Code of the NASD and related interpretation, Regulation T, the rules of the various exchanges and applicable state laws. Further, we would regard it unreasonable to specify any particular period such as ''24 hours after the effective date''. Any such specification would subject an underwriter to unreasonable risk of civil liability. For example, the underwriter might be unable to comply within the specified period because it could not obtain from the printer the necessary statutory prospectus which must be sent or given to the customer prior to or at the same time as the confirmation; or it might be unable to comply because of a breakdown in its electronic data processing equipment. Underwriter self-interest will normally produce the necessary speed.

(b) *Requiring certificates of stock to be delivered or made available for delivery as promptly as reasonably possible.*

Again, we support this recommendation in principle. But any rule would have to take into account the mechanical problems involved in delivering and transferring securities, particularly where relatively unskilled transfer agents are involved. At the closing, the stock certificates are normally delivered in the names of the several underwriters. Before delivery is made to a retail customer, however, the normal pro-

cedure is to put the certificate through for transfer into the name of that customer or as otherwise directed by him. Any specified period of time for delivery, such as "one week after the underwriting closing", would be unfair and impractical.

(c) *Prohibiting the initiation of a trading market for a limited period after the effective date.*

We disagree with this recommendation and believe it would seriously interfere with the raising of capital and, further, would not solve anything. First, raising capital and the distribution process implies liquidity or marketability. The free flow of capital into new public offerings would be seriously impaired by anything that would interfere with the marketability of the new security even for a short period of time. Second, this recommendation would not solve anything, for the problem of excessive demand versus limited supply as it affects the market price would still be with us. Simply put, it would be merely postponed for three days.

The so-called "cooling down" period might well exaggerate, rather than diminish, the demand. Also, in our opinion, this recommendation could create "black market" problems. Trading markets should be available as they are now. Rules 10b-6, 7 and 8 are adequate in this area.

(d) *Soliciting, holding or transmitting, prior to the effective date, of indications of interest or orders to purchase in the open market after that date.*

The scope of this recommendation is not clear. To the extent it recommends restrictions beyond those contained in Rule 10b-6 and the existing laws and regulations prohibiting "manipulative" activities, it seems to contemplate artificial "deflation" of security prices. During the "hot" issue market of the recent past, the ordinary pattern was heavy over-subscription with an initial sharp increase in price above the initial offering price. Artificial "deflation" should not, however, be considered a sound solution to the problem. On balance, we believe that the public interest is best served by having, to the greatest possible extent, free markets in securities, with prices determined upon the

bases of intrinsic and comparative values and current conditions in the markets, including supply and demand. We do not believe that this additional interference with the after market for original distributions is necessary or appropriate.

(e) *Prohibiting solicitations or recommending purchases in the after market.*

We cannot support this recommendation. During the 40 days following the first public offering of securities of a company (or for that matter the tenth public offering by a company) the general securities markets can be and have been such as to make the stock attractively priced even though at a premium of 20% (or more) above the initial offering price. The price at which a stock is recommended involves a value judgment. These judgments differ widely, from time to time, as among firms and within particular firms. It is not unusual for one firm to determine after careful research and analysis that oil stocks should not be held, while another firm reviewing precisely the same material will reach a diametrically opposite result. Some may consider that a price of 20 times earnings in a particular industry is "cheap". Others might determine it to be "fully" or "over" priced. This proposal designed to achieve artificial price "deflation" would, we believe, do more harm than good.

CHAPTER IV B. 3

("Acceleration of First Issues")

The Special Study concludes and recommends:

3. Acceleration by the Commission of the effective date of a registration statement or permitting clearance of a Regulation A filing, with respect to any "first" issue of common stock, should normally be conditioned on delivery of a prospectus or offering circular in substantially final form to each person to whom any participant in the distribution expects to make original allotments at least (say) 48 hours before any sales are made.

This recommendation should be rejected. It would require changes in established methods of distribution by responsible underwriters

which are not warranted on any balance of theoretical benefit against practical detriment. It is based on the theory that a prospective purchaser should have in hand a prospectus for some period of time before the security can legally be sold to him. This theory is no more valid now than when, after careful consideration, it was rejected in the enactment of the Securities Act of 1933 and the 1954 amendments to that Act.

It is not possible to make prospectuses available to all prospective buyers of an issue of common stock (whether the issue be the "first" or "tenth"). Each "first" issue of common stock is not "hot" from the date of the filing of the registration statement. In any issue, shortly before the effective date demand may suddenly occur, increase or decrease. Allotments generally are not made any substantial time prior to the effective date and the selling group of dealers may not be formed until just before the effective date. Simply put, 48 hours before a public offering it is not known "to whom any participant in the distribution expects to make original allotments".

Indiscriminate dissemination of prospectuses to possible buyers has important disadvantages when an issue does turn out to be "hot". Many of those who receive the prospectus, but do not receive allotments, are the customers whose complaints to that effect clutter the files of the underwriters.

Chapter IV B. 4

("Prospectus Deliveries")

The Special Study concludes and recommends:

4. The 40-day period during which all dealers are required to deliver prospectuses should be extended to 90 days in the case of "first" issues of common stock, except as may be otherwise permitted by rule or in specific circumstances. The same provisions should apply to offering circulars under Regulation A exemptions. (It is recommended below that the 40-day requirement be eliminated in connection with offerings of securities of issuers subject to the continuous reporting requirements of Sections 13, 14 and 16 of the Exchange Act.)

This recommendation is properly reflected in the SEC sponsored legislation now before the Congress, and we actively support it.

Chapter IV B. 5

("Free-riding and Withholding")

The Special Study concludes and recommends:

5. The NASD should strengthen its enforcement of the prohibitions against "free-riding and withholding" by requiring, in the case of any "first" issue of common stock for which a price in excess of (say) 120% of the public offering price is reached within (say) 40 days after the effective date, a report of the managing underwriter showing all stock allotted to any participant in the distribution (other than stock resold at or below the public offering price) or its principals or members of their immediate families or to any broker-dealer other than a participant, and the disposition thereof, if any. In general, since those violating the "free-riding and withholding" prohibitions may be in a position to realize profits greatly surpassing the fines customarily imposed by the NASD, substantially severer penalties should be imposed in flagrant cases so as to provide an adequate deterrent.

We support the NASD's interpretation as to "free-riding and withholding", agree that it should be appropriately enforced, and understand that the NASD has made numerous investigations in this area and has continued to increase the severity of its penalties for violations. Rigid formulas (such as 120% premiums in 40-day periods) are generally not useful in enforcement. The NASD should, as a routine matter, consider the market prices of common stocks following their public offering (whether or not they are "first" issues) and investigate (in such manner as it deems appropriate in the particular case) any unusual or significant price rise which follows an offering.

Chapter IV B. 8

("Rule 10b-6")

The Special Study concludes and recommends:

8. In light of widespread misunderstandings or uncertainties among broker-dealers, as discussed in this and other portions of the report, the Commission should take appropriate steps to clarify the

application of rule 10b-6 (a) during a period when stock is being held "for investment" by a broker-dealer, (b) in connection with various forms of "shelf" registration, (c) in connection with a planned reduction of inventory or "workout," and (d) in connection with unregistered distributions generally.

The "appropriate steps" to be taken should include the adoption of more regulations only where it is essential to do so. Proliferation of regulations in this area, particularly with technical and formalistic definitions, is unsound.

Rule 10b-6 was the result of long and cooperative study between the SEC staff and industry representatives. During this period innumerable drafts were prepared and discussed; the effect of the impediments upon issuers and distributors and the benefits to investors were carefully analyzed and balanced; and the keynote was a practical approach to the problems where the restrictions were developed on a pragmatic basis and stated in terms that could be understood and followed by businessmen. Under no circumstances should there be any departure from this practical approach.

The conclusion and recommendation that "the Commission should take appropriate steps to clarify the application of rule 10b-6 (a) during a period when stock is being held 'for investment' by a broker-dealer" presumably has two aspects.

The first aspect is whether it is proper for the broker-dealer to trade during the period he holds the stock for investment. We feel that no clarification is required in this area. Paragraph (c) (3) of rule 10b-6 provides that, in determining when a person "has completed his participation in a particular distribution", he shall be deemed to have "distributed securities acquired by him for investment." Underwriters and dealers who read and seek to comply with SEC rules know that "investment" means "*bona fide* investment", and hence no further clarification is needed for them. For the others, the Commission need only enforce the existing rule.

The second aspect of such conclusion and recommendation relates to the sale by the broker-dealer of the investment stock. Investment

stock registered under "shelf" registration statements should be handled on a case-by-case basis as indicated below. Where the investment stock is not so registered, it should be exempt from rule 10b-6 unless the amount and method of sale are sufficient to constitute a "distribution" as set forth below with respect to a "planned reduction of inventory or 'workout' ".

With respect to the conclusion and recommendation that "the Commission should take appropriate steps to clarify the application of rule 10b-6 * * * (d) in connection with unregistered distributions generally", it seems clear that lack of knowledge by any person that rule 10b-6 applies to "unregistered distributions" can only be caused by a failure to know the contents of the rule itself or the pronouncements of the Commission. The basic clarification recommended by the Special Study, therefore, must be a suggestion that a definition of "distribution" be adopted. Reference is made to this below.

We believe that the Commission should implement on a case-by-case basis the conclusion and recommendation that "the Commission should take appropriate steps to clarify the application of rule 10b-6 * * * (b) in connection with various forms of 'shelf' registration", and should not attempt to adopt any regulation of general application. The words "proposed to be offered", as used in the last sentence of Section 6 of the Securities Act of 1933, were construed for more than two decades to mean "presently" proposed to be offered. "Shelf" registration normally represents a departure from this construction and, in general, may be said to be a peculiar phenomenon developed by the SEC to compel registration where it wished to do so during the active speculative markets of the recent past. With "shelf" registration required by the SEC in many cases where the securities involved had been offered in violation of the Securities Act of 1933, the acuteness of the problem necessarily varied directly with the number of individuals treated as "underwriters" of the securities registered for the "shelf". We believe, therefore, that any problem in this area not covered by rule 10b-6 in its present form can best be handled by the SEC staff through undertakings required in, or in connection with, the "shelf" registration statement to meet the particular facts involved.

If a regulation can be developed which will be simple of application and represent a practical solution of the problems in the area, we believe that it would be feasible to clarify "the application of rule 10b-6 * * * (c) in connection with a planned reduction of inventory or 'workout' ".

Only under most unusual circumstances should such a planned "reduction" or "workout" involve a "distribution". All offerings of inventory acquired for or in the course of trading transactions should be deemed *prima facie* to be trading and not distributions.

It is quite impracticable to attempt to draft a general regulation defining "distribution" for all classes of securities in terms of dollar amounts. The dollar volumes of normal trading activity in over-the-counter debt securities and preferred stocks make such an approach quite unrealistic.

It is also impractical to attempt to define "distribution" in terms of "normal compensation" to salesmen. It is not simple to determine the "normal compensation" paid by a particular broker-dealer to its salesmen in transactions on securities exchanges at fixed commission rates. For the over-the-counter markets, we do not believe it possible to adopt a regulation of general application to all broker-dealers where as among firms there are significant variations in factors relating to "normal compensation" such as mark-up policies, credits to salesmen for different types of customers and the extent to which transactions are effected on a brokerage rather than a principal basis.

If the Commission determines that regulation in this area is essential, we believe that the definition of "distribution" should be limited to common stocks traded over-the-counter and that it should cover public offerings at an aggregate price exceeding $500,000 or 1% of the market value of all the issuer's outstanding common stock, whichever is greater, and in which there is an organized selling group of broker-dealers who are allowed selling concessions.

If such a regulation is adopted, care should be taken not to cast doubt on the fact that the existing rule 10b-6 does not prohibit purchases or bids by a broker-dealer prior to the time that such broker-dealer determines to effect a "distribution" out of "inventory" or of

"investment stock" nor purchases or bids by a broker-dealer prior to the time that such broker-dealer is offered the opportunity to participate in a "distribution" by another person. If such a regulation is adopted, therefore, it should contain a specific exemption to that effect.

CHAPTER VII F. 13
("Disclosures in Certain Retail Transactions")

The Special Study concludes and recommends:

*13. The NASD and/or the Commission should re-examine present requirements with a view to improving disclosures, at the time of soliciting a retail purchase or in confirmations, of essential information relevant to particular types of retail transactions. Among other possibilities that should receive early consideration in this connection would be rules of the following kinds: (a) A broker-dealer soliciting a customer's purchase of any security for which there is no independent market other than its own, or any security out of its own inventory, or any security in which there is a spread of, say, 20 percent or more in prevailing inter-dealer bids and offers, should be required to disclose such fact or facts at the time of solicitation, * * * and (c) The confirmation of a customer's purchase (but not sale), whether handled on a principal or agency basis, should provide an indication of the prevailing spread between inter-dealer bids and offers by showing a representative bid quotation.*

This recommendation seeks to "police" over-the-counter prices through disclosure in solicitations of and confirmations to customers. Whether such disclosure would be understood by the average customer is highly doubtful. But, in any event, this is not a proper approach to any problem encountered in connection with over-the-counter security prices.

Neither the Commission nor the NASD has or should have the power to fix prices in or otherwise to revolutionize the over-the-counter markets, whether by specifying commissions or selling prices, by designating "wholesalers" of securities as "primary market makers", or by

requiring broker-dealers to effect transactions on an agency (rather than a principal) basis.

Selective improvements in this general area can be made by the NASD. The NASD should attempt to make more specific the guidelines contemplated by its "5% mark-up policy". Attempt should be made by it to develop feasible procedures for dissemination of realistic, current over-the-counter retail prices, including dissemination of "narrow" or "wide" market spreads, as may be the actual case for the particular security. The NASD should review its current requirements to ascertain whether they in fact require a broker-dealer to make reasonable efforts under the circumstances to ascertain realistic inter-dealer quotations before executing a customer's order. If not, attempt should be made to formulate a workable requirement to that effect.

CHAPTER II F. 4-8 and 10-12

("Qualifications for Persons in the Industry")

The Special Study concludes and recommends:

4. The individual rather than the firm is the appropriate "unit" for many regulatory purposes, in the interest of fairness as well as efficiency. The present statutory registration scheme does not reach individuals at all, and the self-regulatory concept of "registered representatives" of particular firms does so only partially and indirectly. Without limiting the responsibility of firms for the personnel they employ or the right of firms to select their own employees, there should be established a system of licensing and registering individual salesmen, supervisors and other specified categories of personnel. Each such individual should be required to file a single basic registration form containing necessary data as to his present and prior employment, disciplinary matters, and eligibility under statutory disqualifications, together with a certificate as to his good character and, for applicants without adequate prior experience, as to his successful completion of any required examination. Copies of the basic registration form would be made available to affected regulatory and self-regulatory agencies. Subsequent changes in employment and disciplinary actions should be required to be reported and recorded in the individual file. Duly

licensed persons would be, for regulatory purposes, eligible for employment by any firm.

5. Under such a system of licensing and registering individuals, disciplinary actions could, in appropriate cases, relate to individuals without necessarily involving current or future employers, as is now the case. The present system, under which the Commission may proceed only against a broker-dealer firm, often operates inefficiently or unfairly in that the Commission must move against an employee's firm or not at all. The Commission's powers in this respect should therefore be made more flexible even apart from the recommendation in paragraph 4, so that it will have the power to bring administrative proceedings directly against individuals involved in violations of the securities laws.

6. Apart from statutory disqualifications and requirements for filing of basic data by firms and individuals, standards for entry into the securities business should encompass (a) competence, in the sense of knowledge and experience, (b) character and integrity, and (c) financial capacity and responsibility—the first two applying essentially to individuals and the third essentially to firms. In all three areas there have been significant accomplishments but there are serious gaps and deficiencies that need to be remedied promptly, as set forth in the following paragraphs.

7. The basic regulatory control in respect of competence is the examination. Present examinations and examination programs can and should be considerably improved, refined and coordinated. The standard examination should cover a core of basic subjects for salesmen, supervisors and principals, with appropriate supplemental questions for supervisors and principals, and with such further supplementation as any particular agency may desire for its own purposes. For certain recognized specialties, special supplementary questions should be provided; individuals whose activity (and license to act) is to be limited to any such specialty may be permitted to qualify through appropriately limited examinations. To achieve maximum results with minimum burdens, a National Board of Securities Examiners should be established by and for the various regulatory and self-regulatory agencies, to administer existing programs and foster improved pro-

grams. Through the same or a similar agency, the various existing training programs should be coordinated, extended and improved.

8. Quite apart from knowledge as tested through examination procedures, appropriate experience in the securities business should be a requirement for individuals in certain crucial roles. The individuals for whom there should be an experience requirement include at least one principal in each registered firm and, if other than such principal, the individual designated as being in charge of regulatory and self-regulatory matters, the supervisor of selling activities, the supervisor or manager of each branch office, and the supervisor of research activities. Appropriate periods and types of prior experience are left for future definition.

10. Of all the types of qualifications needed for the securities business, perhaps the most important, but also the most difficult to assure by formal regulation, is that of character and integrity. As rapidly as possible a system involving local "character and fitness" committees, as in the legal profession, should be established. More immediately, the responsibility for maintaining a proper level of character and integrity of all personnel must reside in the individual firm, but with effective enforcement of this responsibility by the self-regulatory agencies. In addition, regulatory and ethical standards should receive greater emphasis in training and examination programs of the self-regulatory agencies. If the latter are to fulfill the role for which they are thought to be uniquely suited, they must also, of course, exert leadership in defining and elevating ethical standards for their members, above and beyond legal requirements.

11. A minimum net capital requirement is of high importance as one of the several different approaches to assuring a broker-dealer community of principals and firms reasonably qualified in terms of responsibility and commitment. The requirement need not and should not be a uniform one for all firms but should be appropriately scaled to reflect the type and size of business engaged in. Subject to exceptions and refinements to be worked out in the future (such as special provision for small proprietorships engaged only in sale of open-end invest-

ment company shares), and subject to an appropriate "grandfather" clause or adjustment period, every broker-dealer should be required to have at the commencement of business, and maintain at all times thereafter, net capital of at least $5,000, plus (say) $2,500 for each branch office and (say) $500 for each salesman employed at any time.

12. Since the underwriting of public offerings involves special obligations and responsibilities, any firm engaging or proposing to engage in underwriting securities offered to the public pursuant to the federal securities laws, whether on a "firm commitment" or "best efforts" or any other basis, should be required to have and maintain minimum net capital of $50,000 plus (say) 2 percent of the aggregate amount of underwriting commitments or undertakings in the most recent 12-month period (but not less than the amount required under paragraph 11).

Many of the topics concerning selling practices contained in Chapter II F of the Special Study Report are the subject of legislation introduced in the Congress on June 4th. This new legislation is required in certain areas where the SEC does not now have the necessary authority. During April and May, representatives of the industry worked in close cooperation with the Commission and its staff in arriving at what we feel is fair and beneficial legislation.

In the areas of "qualification" for entry into the securities business, the SEC has strongly endorsed the concept of self-regulation with government oversight. As the self-regulatory agencies accept this authority, they must also bear the responsibility for fair, equitable, and confidential procedures and tests, and should strive at all times to keep their costs at a minimum consistent with effective action. Prior to the issuance of the Study Report, these agencies had devoted a great deal of attention to this particular field and rather than answer separately each conclusion and recommendation in respect of selling practices in Chapter II F, it seems logical to group and summarize the answers as we have done below.

The Special Study recommendations contemplate that, at both the Commission and the self-regulatory level, an appropriate "unit" of regulation should be the individual and that legislative authority should

be granted to the Commission to establish this. The present statutory system is not directed at individuals—the firm being held responsible for the activities of all its personnel. The present system of reaching security firms' employees is often inefficient or unfair, and therefore the Commission and the self-regulatory bodies should be empowered to move against the individual or, in the event the firm is implicated, both the firm and the individual. We assume that if Congress grants this authority to the SEC, similar authority will be vested in the self-regulatory bodies.

We endorse the suggestion that, "without limiting the responsibility of firms for the personnel they employ, or the right of firms to select their own employees", there should be proper qualification examinations to establish entry into the securities business. Furthermore, that "each such individual should be required to file a single basic registration form containing the necessary data as to his present and prior employment, disciplinary matters, and eligibility under statutory disqualifications" is also logical and acceptable. In fact, such information is now supplied to the self-regulatory bodies and we believe that there is no necessity for an additional filing with a government agency.

Qualification examinations by the New York Stock Exchange and the NASD have been greatly strengthened in the recent past and many of the "gaps and deficiencies" that were criticized in these examinations have been resolved as testing experience has been accumulated. Both organizations now have highly experienced staffs in this field and examinations are given in some sixty-odd test centers in the United States and in consulate offices abroad. Further, each group has announced programs of additional testing for individuals who are accepting additional responsibility in places of supervision or as principals of their firms. The concept of a "National Board of Securities" examiners to administer existing programs and foster improved programs would seem a needless duplication of programs already activated. It should also be pointed out that within the past year both the NASD and the NYSE have published new training guides for those new to the business and the IBA, through its Educational Com-

mittee, sponsors, both at the group level and the national level, a number of training programs designed to prepare people already in the business for positions of additional responsibility.

The Special Study recommends appropriate experience requirements for individuals in "crucial roles". "Experience" is a difficult requirement to assess, although we agree that the person or persons in any particular firm who are in charge of regulatory and self-regulatory matters, supervision of selling activities, branch offices, etc. should have appropriate background in the business. But "experience", as defined in terms of "time", is impractical and unfair. However obtained, competence and maturity of judgment are the measures ultimately sought.

A further recommendation is the establishment of local "character and fitness" committees to review candidates for the industry. We disagree. The self-regulatory agencies should enforce appropriate rules to see that at the time of employment the background of the employee is investigated and evaluated. "Character" also should be a consideration, but here again the evaluation of such an indefinable quality should best be left to the judgment of the employer. The individual firm must have the authority of employment and, therefore, the responsibility to see that those employed meet requisite ethical standards.

Capital requirements also have a significant bearing on selling practices. This is an extremely important and sensitive area, and obviously a firm without sufficient capital cannot provide public customers with proper protection. Minimum capital requirements have always been a concern to the industry—not only upon entry but at all times. It is apparent that any firm, in order properly to conduct its business (making recommendations, effecting transactions, etc.), should maintain a minimum amount of capital at all times. Obviously, minimum capital requirements will not weed out all the undesirables, but such requirements will preclude from the business many who are unable to meet even basic obligations. Certainly any "entry" capital should be the basic "maintenance" minimum.

The Special Study recommends two levels of capital,—one for firms handling underwritings and a lower level for broker-dealers who

are not underwriters. The suggested formula for non-underwriters is unrealistic. Rather, a minimum requirement should be established.

The substantial additional obligations of securities firms who also underwrite are such that the capital requirement for underwriters should provide adequate protection, not only to the public, but also to other dealers, who in turn are obligated to the public. Again, the formula approach included in the Special Study recommendation is unworkable and in active securities markets could render inadequate the net capital of many responsible firms who are actively engaged in the underwriting of securities. The minimum net capital requirement should, we believe, be a fixed amount and adequate (when measured together with the required ratio of indebtedness to net capital prescribed by Rule 15c3-1) to permit the satisfaction of the firm's responsibilities and provide the desired protection to the public.