

The board has the power to suspend, fine, or expel a member for violating the Exchange's constitution or rules or for engaging in conduct inconsistent with just and equitable principles of trade.²²⁹ For a proceeding before the board to commence, a written complaint must be filed by a member or officer of the Exchange. At least seven governors must agree that the complaint should be served on the member involved. Exchange officials indicated to the study that the authorization to serve a complaint has never been refused. Upon the filing of an answer by the member the matter is set down for hearing before the board, a division management committee, a standing or special committee, or a designated hearing examiner. Unless the board determines otherwise the member or member firm is entitled to be represented by counsel. This right is rarely exercised. After hearing the case, the committee or hearing examiner files a recommended decision with the board, which may accept, reject, or modify the decision.

A member may request a rehearing before the board in the event of an adverse decision. In addition, any member or member firm expelled by the board may appeal the decision to the entire membership. Exchange officials stated that no such appeals to the membership have ever been taken.

As described in section 2 above, there are three standing committees with regulatory responsibilities, auditing, floor trading, and ethics and business conduct. Matters involving financial difficulties or back-office problems of member firms are generally referred to the auditing committee, except "simple" capital problems which are capable of staff disposition. Normally, the auditing committee recommends a decision to the division management committee, but the staff may refer serious capital violations directly to the division management committee.

The work of the floor trading committee, which is responsible for floor supervision, is discussed below in section 5. The ethics and business conduct committee handles admissions, disputes among members, and a broad range of disciplinary matter not within the jurisdiction of any of the other standing committees. It makes recommendations to the division management committee which in turn recommends to the full board.

Disciplinary actions that are referred to a standing committee, a division management committee, or the board are generally handled with considerable informality. The principal exception in recent years was a case involving Pledger & Co., which resulted in the suspension of the firm's membership for 6 months. A formal complaint was served, testimony was taken, hearings were held, and counsel were present on behalf of the member and the PCSE. The case, which involved violations of the Securities Act, was heard by a combination of governors and ethics and business conduct committee members serving as hearing examiners.

In the few disciplinary cases involving registered representatives, the same procedures are followed as in those cases involving members. The PCSE is of the view that a firm is responsible for its employees, and if it takes action against a registered representative, it will generally also take action against his firm.

²²⁹ PCSE constitution, art. XII, describes the disciplinary procedures of the Exchange.

The Exchange releases to the press information regarding suspensions or expulsions, including the names of the persons or firms involved. In other cases, only the membership is advised of the penalty and the names of the individuals or firms are withheld.

4. SURVEILLANCE AND ENFORCEMENT OF OFF-FLOOR REQUIREMENTS

The PCSE relies principally on financial questionnaires, audits, and visits to member firm offices for surveillance of off-floor requirements. It requires PCSE-only firms to file annually two short-form unaudited questionnaires and one long-form audited questionnaire. Since January 1963, the audit has been required to be on a surprise basis. These three questionnaires must be filed at different times during the year. Member firms holding NYSE memberships file copies of their NYSE questionnaires with the PCSE. Since September 1962, each PCSE-only firm has been required to file a monthly computation of capital in addition to the three financial questionnaires.

PCSE auditors make two types of visits to the offices of member firms: a full-scale review of the firm's operation and a spot check of particular matters; e.g., net capital and Regulation T compliance. All PCSE-only firms received one or two full-scale reviews and between one (for most firms) and four (for one firm) spot checks during 1962. The Exchange's treasurer and his assistant perform the examinations in San Francisco, while two auditors under the supervision of a vice president perform them in Los Angeles.

Although the forms used by the auditors in San Francisco and Los Angeles differ, they cover much the same subjects. The visits are concerned with such matters as net capital, Regulation T, margin, conduct of accounts, handling of orders, fails, and underwritings. The information obtained about underwritings is employed principally to determine the impact of underwritings on the firm's capital position.

After he completes his review of a firm, the Exchange auditor discusses his findings with the member or one of the partners. A letter is always written to the firm after a full-scale review summarizing the findings, even if nothing improper is discovered. If something improper is found on a spot check visit, the firm is so advised in writing.

If a financial questionnaire or visit by an Exchange auditor discloses a net capital violation,²³⁰ the PCSE gives the firm a deadline to correct the violation (generally about 2 days). Once the deficiency is corrected, the matter is generally considered closed. If there has been a pattern of violations, however, or if a member firm fails to correct its capital deficiency within the specified period, the matter may be referred for appropriate disciplinary action to the auditing committee or division management committee. The Exchange had seven disciplinary cases involving its net capital rule during the years 1957-62, four of which were in 1962.²³¹

Exchange auditors spot check customer accounts regarding Regulation T and margin maintenance requirements if the firm is a large

²³⁰ The PCSE's net capital rule is discussed in ch. II.B.3.a(4). The Exchange is exempt from the Commission's net capital rule under rule 15c3-1(b)(2) under the Exchange Act.

²³¹ In all, 19 cases involving member conduct were instituted during 1957-62.

one and examine all accounts if the firm is a small one. If there are serious violations, the staff recommends disciplinary action.²³²

The PCSE has no systematic program of supervising the selling practices of its members. Its auditors do not visit the branch offices of member firms or talk to salesmen, and although they look for over-activity of customer accounts in the course of their visits they have not turned up instances of selling abuses.

In recent years few complaints have been received by the PCSE from the public regarding selling practices by member firms, and those that were received were not vigorously pursued. Chapter III.B.6 (b) (4) refers to four complaints from customers of a particular salesman, alleging various improper selling practices. The matter was turned over to the firm without the PCSE's conducting its own thorough investigation.

Another public investor wrote to the Exchange claiming that:

In 1960 (July 29) a member of the brokerage firm of [an NYSE-PCSE member] * * * used high pressure salesmanship to get me to buy a stock that I had never heard of up to then. Of course, I don't remember everything he said but he strongly urged me to buy this stock, Biochemical Procedures, which I did. I remember he said that it would go up 50 percent in a couple of months.* * *

The Exchange conducted no investigation of the matter. It advised the investor:

We have your letter of August 9, 1962, together with the correspondence you have had with * * * in connection with a purchase of Biochemical Procedures stock in 1960.

You realize that many stocks have dropped in value in the last 2 years and particularly within the past year. I am sure you further realize brokers cannot cancel all trades when the market has declined. The question appears to be one based on the determining factors as to the decision for purchasing the stock at the time.

The basis [for] the information contained in your letter is not sufficient for the Exchange to take action.

The Exchange requires PCSE-only members to submit their advertisements in advance for approval "unless in general form requiring no approval."²³³ Exchange officials noted that the advertisements were generally routine in nature. The PCSE has no systematic method of policing market letters and sales literature.

The enforcement of off-floor requirements by the PCSE is confined to sole members. It relies entirely upon the NYSE for surveillance and enforcement of the activities of members of both exchanges. The PCSE receives copies of questionnaires filed by dual members with the NYSE but does not receive reports of NYSE disciplinary actions against dual members unless the action is made public.

5. SURVEILLANCE AND ENFORCEMENT OF FLOOR REQUIREMENTS

The floor trading committee is responsible for the supervision of conduct on the floor. The staff of the Exchange brings matters to the attention of the floor trading committee and acts in a factfinding capacity.

The PCSE's market surveillance program is concerned exclusively with sole listings. Market surveillance of dually traded stocks is left to the primary market. The staff, as well as the floor trading committee,

²³² Three disciplinary cases involving Regulation T were instituted during 1957-62.

²³³ PCSE rule XVI.

checks the daily transactions sheets for PCSE-only stocks that show unusual activity. In addition, floor trading committee members are on the floor and are expected to note unusual activity. If trading in a sole listing warrants investigation, the staff conducts a market study. Exchange auditors check the buyers and sellers in the stock over the period in question and examine the firms and possibly registered representatives.

The PCSE has no systematic method of determining whether a customer received as good an execution on the PCSE as he would have received in New York. It relies on the servicing broker to check this.

The PCSE has no reporting requirements for its specialists. The specialists are not required to inform the Exchange on a regular basis of their trading in stocks in which they are registered, except that the Exchange has considerable data available as to those specialists for whom it does bookkeeping. The PCSE has no statistical or systematic measure of specialist performance in either sole or dual stocks. The Exchange relies on "feel" and the opinion of brokers to determine whether or not its specialists are making good markets. The Exchange has taken no disciplinary actions against specialists since it was organized in 1957.

The PCSE's specialist capital requirements (\$50,000 liquid capital) are checked by the Exchange through its financial questionnaires and visits to member firms. Since the Los Angeles division does the bookkeeping for all specialists in that division, and the San Francisco division does the bookkeeping for two of its specialists, the Exchange is able to supervise closely the financial condition of those specialists.

The procedure for allocating newly admitted stocks to specialists is identical for dual and sole listings. All specialists are invited to apply to the floor trading committee. If there are several applicants, the Exchange may ask for information from each applicant as to why he should be allocated the particular stock. Issuers may recommend that the stock be allocated to a particular specialist, but such recommendations are discouraged by the committee. If a specialist induced a listing, which apparently occurs infrequently, the committee gives consideration to that factor. Exchange officials indicated that the committee draws upon its personal knowledge of the applicants in making allocations. Since each division is quite small, committee members are aware of the abilities of the various specialists, according to exchange officials. The staff generally makes no recommendation as to allocations.

The Exchange has no requirement that members report transactions for their own account, either on or off the floor. Exchange officials indicated that there were two active floor traders in San Francisco and that some of the Los Angeles specialists trade in securities other than those in which they are registered. The Exchange has no special restrictions on floor trading.

6. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The Pacific Coast Stock Exchange is important as a securities market because of its present business and its potential for future growth. As with the Midwest Stock Exchange, some of the larger NYSE commission firms are also members of the PCSE and a substantial percentage

of trading on the PCSE takes place in securities that are also listed on one of the New York exchanges. The primary thrust of the PCSE's regulatory effort is directed at sole members and securities traded only on that exchange.

The PCSE is the product of the consolidation of the Los Angeles and San Francisco Stock Exchanges. Considerable effort is expended in keeping the two divisions on an equal basis in the government of the Exchange. Each division has control over its own finances and has its own traditions and procedures. Although there has been progress in recent years toward making the regulatory practices of the two divisions uniform, there are still areas in which varying practices exist.

The government of the Exchange is vested in its board of governors. However, because of the geographic distance between the two divisions the division management committees (consisting of the governors from the respective divisions) have considerable authority over the affairs of their respective divisions.

The PCSE is unique among the four largest exchanges in the degree to which its board and committees participate directly in the self-regulatory operation and management of the Exchange. In addition to assisting in the formulation of policy, the division management committees and the standing committees exercise important regulatory and administrative functions. Disciplinary and policy matters are channeled through the committees whose decisions are generally adopted by the board, whereas the paid staff occupies a less important position in the regulatory structure than in the NYSE, Amex, or MSE. It acts in a factfinding capacity under the direction of the board and the various committees and is responsible not only to the president of the Exchange but also directly to the board. The president does not have the right to vote at meetings of the board or division management committees.

Experience has demonstrated that in an exchange of substantial size this kind of arrangement is of less than maximum effectiveness and has within it the potential for abuse. The reforms adopted by the NYSE in 1938 and those adopted by the Amex in 1962 incorporated the concept of a paid staff with the authority to operate the Exchange. The report of the Levy Committee, the industry group that studied the Amex, concluded that the standing committee system, among other things, resulted in an absence of well-defined responsibility and the assumption by the committees of greater powers than the president or the board, and was an obstacle in the development of necessary staff initiative. A reorganization of the PCSE in the direction taken by other important exchanges seems highly desirable in light of their experience.

In its surveillance and enforcement of off-floor requirements, the Exchange puts most emphasis on its net capital rule. Members' selling and advisory activities receive inadequate attention, and the Exchange's handling of public complaints should be strengthened.

The Special Study concludes and recommends:

1. The PCSE, under the supervision of the Commission, should undertake a thorough examination of its organizational structure with a view to providing a paid staff of adequate size and authority

for self-regulatory functioning in lieu of the present reliance on a committee system.

2. Consideration should be given to the elimination of those constitutional provisions which may unduly restrict the board in the exercise of its authority, for example, the constitutional provision which bars the board from acting on a matter that "solely concerns the internal affairs or assets" of a division and the one which permits a member expelled by the board to appeal the expulsion to the membership.

3. Certain recommendations in other parts of chapter XII, especially part B, may apply directly or with appropriate adaptation to the PCSE; e.g., the recommendation as to publicizing disciplinary actions. Commission and Exchange representatives should undertake to determine the possible applicability of such recommendations and the Exchange should proceed to implement such recommendations or adaptations as may be found appropriate.

F. THE OTHER EXCHANGES AS SELF-REGULATORY INSTITUTIONS

Previous parts of this chapter assessed the regulatory performance of the NYSE, Amex, MSE, and PCSE. In 1962 these four Exchanges accounted for 98 percent of the dollar volume and 97 percent of the share volume of securities traded on all exchanges. This part deals very briefly with the organization and regulatory activities of the other registered securities exchanges.

There are 10 other registered national securities exchanges—the Chicago Board of Trade,²³⁴ and the Boston, Cincinnati, Detroit, National,²³⁵ Philadelphia-Baltimore-Washington, Pittsburgh, Salt Lake, San Francisco Mining,²³⁶ and Spokane Stock Exchanges. The Colorado Springs, Honolulu, Richmond, and Wheeling Stock Exchanges have been exempted from registration under section 5 of the Exchange Act—

because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

It should be emphasized that these exchanges vary substantially in size and the kinds of securities traded. For example, a substantial part of the trading on the Philadelphia-Baltimore-Washington and Boston Stock Exchanges, which in 1962 ranked fifth and sixth in dollar volume of securities traded, was in stocks listed on one of the major New York exchanges; on the other hand, the three western mining exchanges—Salt Lake, San Francisco Mining, and Spokane—traded almost exclusively in securities listed only on those exchanges and selling below \$1 a share.

The Special Study was unable to examine in detail the organizations and regulatory activities of these exchanges. Its inquiry was

²³⁴ The Chicago Board of Trade has had no securities transactions since Sept. 22, 1953. Its operations are not discussed in this part.

²³⁵ The National Stock Exchange commenced trading on Mar. 7, 1962. Its operations are not discussed in this part.

²³⁶ The Commission ordered proceedings in July 1962 pursuant to sec. 19(a)(1) of the Exchange Act to determine whether the registration of the San Francisco Mining Exchange should be withdrawn. This was the first such proceeding ever brought by the Commission. At the time of the writing of this report the matter was pending. Securities Exchange Act release No. 6865 (July 30, 1962).

confined to a review of their constitutions and rules, a study of Commission files, and receipt of information from the exchanges relating to their organization, staff structure, and financial condition. This part concentrates on the Boston and Philadelphia-Baltimore-Washington Stock Exchanges because of the amount of trading conducted on those exchanges.

1. ORGANIZATION AND GOVERNMENT

Each of the eight registered exchanges discussed in this part vests authority to operate the exchange and regulate member conduct in a governing committee.²³⁷ The governing committee consists of members and partners of member firms. For instance, the Governing Committee of the Boston Stock Exchange is composed of the president, vice president, and treasurer, all of whom must be members, and 12 other governors, 7 of whom must be members, and 5 of whom may be non-members, provided that they are partners of member firms engaged in a business involving direct contact with the public.²³⁸ The board of governors of the Philadelphia-Baltimore-Washington Stock Exchange consists of the president and 21 other governors, at least 14 of whom must be members and the remainder must be general partners of member firms or officers of member corporations.²³⁹

The exchanges also utilize standing committees that have responsibility in substantive areas such as admissions, floor procedure, and outside supervision. The standing committees, consisting of governors and members, exercise important regulatory functions in matters falling within their jurisdiction. None of these exchanges has public governors.

The chief executive officer of the exchange is either the chairman or the president. In either case, he is usually not a full-time paid executive but is associated with a member firm.²⁴⁰

The staffs of the respective exchanges vary considerably in size, depending in part on the amount of business done on the exchange. As might be expected, the Philadelphia-Baltimore-Washington and Boston Stock Exchanges have the largest staffs, 41 and 22 employees, respectively. The Cincinnati and Pittsburgh Exchanges each has a total of four employees, while the staffs of the western mining exchanges range from one to three full-time employees. Since the members of the exchanges, through their governing and standing committees, operate the exchange as well as exercise regulatory authority, the paid staffs have a relatively minor role in administration and regulation.

The income and resources of the exchanges also differ considerably. For example, the 1961 income statement of the Philadelphia-Baltimore-Washington Exchange shows "total income" of \$390,362, resulting in "net income from operations" of \$12,679. The Boston Stock Exchange had "total operating income" of \$237,672 (which resulted in a net operating loss of \$97,669) and a surplus at the end of 1961 of \$945,813. The Spokane Stock Exchange had the smallest gross reve-

²³⁷ The "governing committee" may be called, variously, a board of governors, board of directors, or board of trustees.

²³⁸ Boston Stock Exchange constitution, art. II.

²³⁹ Philadelphia-Baltimore-Washington Stock Exchange constitution, art. II, sec. 1.

²⁴⁰ Only the Cincinnati Stock Exchange has a nonmember paid president, who also serves as secretary of the exchange.

nues of the registered exchanges in 1961, \$8,692, resulting in a net loss of \$390.

2. REGULATION OF CONDUCT

The Boston Stock Exchange vests exclusive authority to try charges against members and punish rule violations in its governing committee.²⁴¹ The committee may require that a member submit books and records to it or any committee.²⁴² In order to institute a full-scale disciplinary case a member must be served with written, detailed charges. He is entitled to answer the charges and to a hearing before the governing committee.²⁴³ In the alternative, the governing committee may proceed by means of a summary procedure in which the member is summoned before the committee, informed of the nature of the accusation against him, and given an opportunity for explanation. The maximum penalty which may be imposed under this summary procedure is a suspension for 60 days.²⁴⁴ Suspension may be imposed by a vote of a majority of all members of the committee and expulsion by a vote of two-thirds of all members of the committee.²⁴⁵ A disciplinary decision of the governing committee may be appealed to the membership on the written request of 25 members.²⁴⁶ A member is not entitled to be represented by counsel in any investigation or hearing before the governing committee or any standing or special committee.²⁴⁷

The disciplinary procedures of the Philadelphia-Baltimore-Washington Stock Exchange require that a member be served with written charges which he is entitled to answer and contest at a meeting of its board. The board has authority to suspend (by a vote of 12 of its 22 members) or expel (by a vote of 15 of its 22 members).²⁴⁸ Standing committees have the authority to fine a member \$250 for each offense in respect of any matter within the jurisdiction of the committee.²⁴⁹ In proceedings before the board a summary procedure may be employed in which the maximum penalty is \$250 or a 30-day suspension.²⁵⁰ A member is not entitled to be represented by counsel in any investigation or hearing before the board or any standing or special committee.²⁵¹

The study did not inquire into the surveillance procedures of these eight exchanges. A compilation was made, however, of the disciplinary cases reported by them to the Commission from January 1, 1953, through December 31, 1962, the results of which appear as table XII-5.

The method by which some of the exchanges report disciplinary actions to the Commission made it somewhat difficult to classify certain of the decisions. Some of the exchanges merely report the name of the member involved and the section of the exchanges' constitution or rules which was violated. The facts on which the decision was based are not given. This kind of reporting makes the task of Com-

²⁴¹ Boston Stock Exchange constitution, art. III, sec. 2, 3.

²⁴² *Id.*, art. XVI, sec. 8.

²⁴³ *Id.*, art. XVI, sec. 10.

²⁴⁴ *Id.*, art. XVI, sec. 11.

²⁴⁵ *Id.*, art. XVI, sec. 1.

²⁴⁶ *Id.*, art. X, sec. 1.

²⁴⁷ *Id.*, art. XVI, sec. 13.

²⁴⁸ Philadelphia-Baltimore-Washington Stock Exchange constitution, art. XIX, sec. 1, 14.

²⁴⁹ *Id.*, art. XI, sec. 2.

²⁵⁰ *Id.*, art. XIX, sec. 15.

²⁵¹ *Id.*, art. XIX, sec. 21.

mission oversight more difficult since the Commission is without essential facts to judge the exchanges' regulatory performances.

3. SUMMARY

With respect to the registered national securities exchanges apart from the NYSE, Amex, PCSE, and MSE, the study's inquiry was generally confined to a limited review of their constitutions and rules. Since no study was made of their surveillance and disciplinary procedures, it is impossible to draw conclusions as to the effectiveness of their regulatory activities.

Despite wide differences among these eight exchanges, certain organizational similarities exist. Operation of the exchange is generally vested in a governing committee and in standing committees with authority in specified substantive areas. The role of the paid staff is relatively minor and, except for the larger of these exchanges, the staffs are quite small.

On numerous occasions since the passage of the Exchange Act the need of registered exchanges for qualified staff personnel with sufficient authority has been demonstrated. The developments at the Amex in 1962 are but the most recent illustration. The paid staff affords continuity of administration as well as the critical element of objectivity. To the extent this is not economically feasible for some of the smaller exchanges, there is a corresponding limit on what may be expected of self-regulation, and the Commission's direct regulatory activity must be adapted accordingly.

Other parts of this chapter, particularly those dealing with the NYSE, contain recommendations pertaining to the organization and regulatory performance of that exchange. It is not possible within the confines of this report to indicate the applicability of each recommendation to each registered securities exchange, nor has it been possible to analyze the special circumstances of each exchange to determine in what respects changes are desirable. Consequently, on the basis of an assessment of the applicability of the recommendations to the particular exchange, each exchange should make such changes in its rules, practices, and procedures as may be appropriate.

G. THE NASD AS A SELF-REGULATORY INSTITUTION

1. INTRODUCTION

Of the self-regulatory organizations the National Association of Securities Dealers, Inc. (NASD or association), has the largest number of members. It owes its position largely to the character of the over-the-counter markets which it regulates and to the statute governing its operation.

The over-the-counter markets are residual markets in that they encompass all securities business not done on the organized exchanges.²⁵² All broker-dealers registered with the Commission may participate in over-the-counter trading and, with few minor exceptions, are entitled to join the NASD.²⁵³ Unlike the exchanges, the NASD can-

²⁵² See ch. VII.B.

²⁵³ See ch. II.B.2.

not select its membership—it is compelled to open its doors to all qualified persons.

The membership of the NASD has come to be nationwide. It includes virtually all broker-dealers engaged in a general securities business, representing wide diversities in financial resources, standards, and activities. In 1939, the NASD commenced operations with a membership of 1,500 firms, comprising 22 percent of approximately 6,700 broker-dealers registered with the Commission. By December 31, 1962, association membership had grown to 4,771, or 83 percent of 5,724 registered firms.²⁵⁴ When the association began its registered representative program in 1945, the program covered about 25,000 individuals. By December 31, 1962, that figure had reached 94,444, encompassing the vast majority of securities salesmen.

While the NASD's scope of responsibility is very broad, its primary responsibility relates to the over-the-counter markets. The diffuseness and heterogeneity of these markets, described in chapter VII, as well as the diversities in the character and standards of its membership complicate the regulatory task of the NASD. Whereas trading on an exchange is concentrated in a central marketplace where it can be observed and supervised, trading on the over-the-counter markets takes place throughout the country over a telephone-and-wire network connecting members bilaterally and privately with one another. The lack of a "tape" or other means of reporting and publicizing transactions results in an absence of continuing information about market activities.

Another factor increasing the complexity of the regulatory task assigned to the NASD is the recent dramatic growth in the over-the-counter markets. This growth has outpaced the ability of all regulatory agencies, including the Commission, to deal with the numerous problems created by the increase in the volume of trading and participating broker-dealers.

The NASD is a creature of statute and it is primarily engaged in regulatory activities. Unlike the exchanges, it did not exist as an organization prior to the adoption of the Exchange Act; the NASD was specifically established to govern conduct in the over-the-counter markets. Except insofar as it supervises the dissemination of retail quotations and sponsors a clearing arrangement, the NASD is not directly engaged in the operation of a marketplace or its ancillary facilities and its members are not "seat" holders with a proprietary interest in a marketplace.

This part of chapter XII, after briefly setting forth the background and structure of the NASD (sec. 2), contains a detailed description of the organization and functioning of the NASD (sec. 3) and its fiscal policy and planning (sec. 4). In a succeeding section the regulatory activities of the NASD are reviewed and analyzed and its regulatory performance related to its organization (sec. 5).

Other chapters of this report have discussed various substantive rules and policies of the NASD and assessed their adequacy for the protection of investors. Chapter II covered NASD controls over entry into the securities business; chapter III, selling practices, investment advice, and financial responsibility; chapter IV, underwriting and distribution practices; chapter VII, over-the-counter trading mar-

²⁵⁴ See table I-18, ch. II.B.2 and ch. II.F.

kets; and chapter XI, NASD controls over mutual fund selling practices and reciprocal business. Each of these chapters describes major areas of the securities business of concern to the NASD and assesses the regulatory performance of the NASD in relation to a particular area. A total picture of the NASD requires that this part be considered together with the above material in prior chapters.

The study's inquiry into the regulatory process of the NASD took several forms. At the outset, the NASD was asked to furnish certain basic materials, including minutes of meetings of the board of governors, executive committee, and district secretaries, and various reports and studies. These materials as well as materials in the files of the Commission and data obtained from the NASD relating to substantive areas were reviewed and analyzed. At various times throughout the study, certain NASD district offices were visited and NASD officials were interviewed in private hearings. The chairman of the board of governors and the association's executive director testified at public hearings conducted by the study in May 1962 on the subjects of qualification for entry into the securities business and selling practices.

Since the inception of the Special Study, there have been numerous changes in NASD organization and in regulatory practices and procedures. Much of the discussion in this chapter relates to the NASD as it existed at the end of 1961. The large number of changes, both major and minor, which have been made while this report was in preparation has made it impossible to note each change in relation to the discussion of a particular topic, but where practicable, this has been done. Most of these recent developments are summarized in a section prior to the conclusions and recommendations (sec. 6).

2. BACKGROUND OF THE NASD AND ITS STRUCTURE AS A REGULATORY INSTITUTION

a. Historical background

Regulation of the over-the-counter markets has developed in several stages. While comparatively little was known about these markets in 1934 when the Exchange Act became law, it was early recognized that their regulation was necessary, since "to leave the over-the-counter markets out of a regulatory system would be to destroy the effects of regulating the organized exchanges."²⁵⁵ Because of the potential scope and complexity of over-the-counter regulation, the statute entrusted to the Commission broad rulemaking powers over the over-the-counter markets rather than creating a detailed system of regulation as in the case of the exchanges.²⁵⁶ However, as one member of the Commission described the task of direct government regulation of the over-the-counter markets without a self-regulatory organization:

[It] is a little bit like trying to build a structure out of dry sand. There is no cohesive force to hold it together, no organization with which we can build * * *²⁵⁷

Throughout the early years of the Commission, a strong industry movement directed at organizing broker-dealer participants in the

²⁵⁵ "Stock Market Control," Twentieth Century Fund, p. 668 (1934).

²⁵⁶ Other chapters of the report have described Commission regulation of the over-the-counter markets prior to organization of the NASD. See chs. VII and IX.

²⁵⁷ Testimony of Commissioner George Matthews, "Hearings on S. 3255," 75th Cong., 3d sess., p. 7 (1938).

over-the-counter markets was underway. The depression of the early 1930's helped to provide a nucleus around which to build. Under the National Recovery Administration (NRA), the Investment Bankers Code Committee was formed in 1933 to prepare and enforce an industry code. Although the code organization was stripped of its powers 2 years later by the *Schechter* decision,²⁵⁸ it nevertheless continued in existence at the urging of the Commission's first chairman, Joseph F. Kennedy, and his successor, James M. Landis. In October 1935, the activities of the code organization were assumed by the Investment Bankers Conference Committee, which had been established to formulate under Commission supervision a voluntary program of industry self-regulation. It was soon realized, however, that the desired objectives could not be achieved without appropriate legislation, particularly legislation exempting the activities of an industry-wide organization from the antitrust laws. A legislative program was devised and the functions of the conference committee were assumed in October 1936 by a new group, the Investment Bankers Conference, Inc. (IBC), formed to implement a legislative program. Through the combined efforts of the Commission and the IBC and the support of a large segment of the securities industry, the Maloney amendment (named for its sponsor, the late Senator Francis Maloney of Connecticut) to the Exchange Act was enacted in 1938, providing for Government and industry cooperative regulation of over-the-counter securities markets.²⁵⁹

Self-regulation in the over-the-counter markets under the Maloney Act was to be accomplished by permitting qualified associations of broker-dealers to register with the Commission as "national securities associations."²⁶⁰ As an inducement to joining, the act permits a registered association to prohibit its members from dealing with non-members "except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public."²⁶¹

To become registered, an association must meet certain standards. It must be appropriately organized by reason of the number and geographical distribution of its members and the scope of their transactions to be able to comply with and carry out the purposes of the act; it must admit to membership all qualified broker-dealers and continue in membership those who remain qualified; it must insure a certain degree of internal democracy in the administration of its affairs; its rules must meet certain broad objectives;²⁶² and, of primary importance, it must discipline those who violate its rules.

The writings and public statements of the period indicate that the self-regulatory objectives of the act were twofold: first, to bring about

²⁵⁸ *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

²⁵⁹ For the background and legislative history of the Maloney Act see S. Rept. 1455 and H. Rept. 2307, 75th Cong., 3d sess. (1938); speech of Chairman William O. Douglas before the Bond Club of Hartford, Jan. 7, 1938.

²⁶⁰ The Maloney Act provisions applicable to such associations are contained in sec. 15A of the Exchange Act.

²⁶¹ See Exchange Act, sec. 15A(i)(1).

²⁶² Sec. 15A(b)(7) requires that "the rules of the association [be] designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and * * * not [be] designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts or other charges * * *."

self-discipline in conformity to law—"voluntary law obedience so complete that there is nothing left for government representatives to do"—and, secondly, to encourage "obedience to ethical standards beyond those any law can establish." The end product of such a system would be to put the over-the-counter markets on a "highly professionalized plane" and at the same time "afford to the investor a service characterized by efficiency commensurate with its economic importance * * *." ²⁶³ It was thought that this kind of self-regulation was far preferable to detailed and pervasive regulation by the Government which might be overly burdensome to business and Government alike.

Senator Maloney, shortly after enactment of the legislation, described the allocation of regulatory responsibilities between the NASD and the Commission in this way:

* * * Congress has undertaken to provide a mechanism whereby the securities business of the country may deal with all problems of technical regulation, leaving to the Securities and Exchange Commission what it is hoped will be the residual position of policing the submarginal fringe which recognizes no sanctions save those of the criminal law and of dealing with those problems of regulation with which the industry, as organized under the act, finds itself unsuited or unable to deal. ²⁶⁴

The existing allocation of regulatory responsibility between the exchanges and the Commission was envisioned as the basic pattern to be followed, but "with 1938 improvements." ²⁶⁵

Shortly after the act became law, a joint committee composed of representatives of the Investment Bankers Association and IBC indicated that it conceived of the new association as a strong national organization, and the Commission gave its early approval to this concept. Although the statute permitted the registration of national securities associations organized on a regional or functional basis or "on such other specified and appropriate basis," ²⁶⁶ the Commission encouraged the formation of a single national association. In response to a letter sent by the director of the IBC and the present executive director of the NASD, the then chairman of the Commission stated:

[W]e feel that the best form of organization would be a strong national association, truly representative, including the small as well as the large elements in the business. It seems to us that a strong national association can best deal adequately and effectively with the important questions which will arise under the statute; and cope effectively with the problems of an industry which is truly national rather than local in character.

Following conferences between the Commission and industry representatives and the obtaining of a new corporate charter, the old IBC emerged as the NASD. Shortly after its formation an application was filed with and approved by the Commission in the summer of 1939. ²⁶⁷

In its decision approving the association's application for registration under section 15A, the Commission expressed the view that there was "minimum compliance" by the NASD with the requirements of

²⁶³ See note 259, above.

²⁶⁴ Address to California Security Dealers Association, Investment Bankers Association, and NASD, San Francisco, Aug. 22, 1939.

²⁶⁵ See pt. 1, below.

²⁶⁶ See Exchange Act, sec. 15A(b)(3).

²⁶⁷ *In the Matter of Application by National Association of Securities Dealers*, 5 S.E.C. 627 (1939).

the statute in several respects. The Commission noted that the by-laws left to the discretion of the board of governors whether the affairs of the association were to be managed largely by a professional staff or by volunteer members:

Should the board of governors elect the latter course it would appear doubtful whether effective enforcement of the association's rules of fair practice could be secured. It is the opinion of the Commission that such enforcement will, in all probability, require a staff of paid employees to be expanded to a nationwide scale in due course of time, headed up by a chief executive endowed with sufficient powers to render him effective.²⁶⁸

The Commission also indicated that there was "minimum compliance" with the statute in connection with the association's dues schedule. The Commission observed that it seemed "entirely arguable" that firms with a large personnel would pay a disproportionately small share of the association's expenses and that, as a result, association revenues might be insufficient for it to perform its self-regulatory tasks adequately. In this area, as well as others, the Commission indicated that it would observe the operations of the NASD to ascertain whether association rules and practices complied with the objectives of the statute and whether Commission surveillance of the activities of the NASD members in areas subject to its self-policing would be necessary.

b. Structure of the NASD

The NASD is a private nonprofit corporation organized under the laws of Delaware. It has the following stated objects and purposes:

(1) To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and to encourage and promote among members observance of Federal and State securities laws;

(2) To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;

(3) To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors;

(4) To promote self-discipline among members, and to investigate and adjust grievances between the public and members and between members.²⁶⁹

The association is nationwide in scope and is organized to obtain a maximum degree of local administration of its affairs. To accomplish this the association is divided into 13 regional districts.²⁷⁰ In addition to administering the local affairs of the association, the 13 districts are responsible for providing representatives to the 21-member board of governors in whose control the overall management and supervision of the association rest. The board has a chairman and certain lesser officers; it oversees a paid staff of some 160.²⁷¹ It also has both standing and special committees, some of which are composed of non-board members and some of which have their own administrative staff.

²⁶⁸ Id. at p. 628.

²⁶⁹ Certificate of Incorporation, art. III.

²⁷⁰ See table XII-6.

²⁷¹ As of Dec. 31, 1962.

The association has adopted rules of fair practice and a uniform practice code. The former governs the professional conduct of association members and the latter specifically deals with technical methods of executing transactions and conducting a securities business.

There are 26 rules of fair practice. They range from the very broad ("a member in the conduct of his business shall observe high standards of commercial honor and just and equitable principles of trade"²⁷² and "no member shall effect any transaction or induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance,"²⁷³) to the specific ("no member shall * * * join with a nonmember broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities").²⁷⁴

The 13 regional districts are initially responsible for enforcing the rules of fair practice. Each district is managed by a district committee composed of from 6 to 18 members and a paid staff headed by a district secretary. These committees double as district business conduct committees and as such initiate charges against rule violators, hear and determine such charges, and assess penalties which may range from a censure or fine to suspension or expulsion from membership.

District business conduct committee decisions are reviewable by the board of governors either on appeal by the disciplined member or on its own motion. The Maloney Act, unlike the original Exchange Act applicable to exchanges, contains certain specifications as to the conduct of disciplinary matters. Commission and ultimate court review of association disciplinary actions are also provided for by the statute.²⁷⁵

3. NASD ORGANIZATION AND FUNCTIONING

a. Underlying principles

Three closely related principles have guided the NASD in carrying out its policymaking and administrative functions. Each has received varying degrees of emphasis over the years but all appear to retain some degree of vitality and basic validity.

The first principle, emanating from the legislative background of the Maloney Act, is that of a democratic organization. It arose, historically, out of early fears of monopoly and oppression of the "little fellow" and minority segments of the business. If broker-dealers seeking to engage in a general securities business were to be economically compelled to become members of the NASD, then it was thought necessary to provide safeguards of various kinds, including the requirements of representative governing bodies. This principle was incorporated in section 15A(b)(5) of the Maloney Act, which requires that the rules of the association "assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs." The Commission and the NASD have interpreted "fair representation" to require that factors of geography, size of firm, and kinds of business be considered.

²⁷² Art. III, sec. 1.

²⁷³ Art. III, sec. 18.

²⁷⁴ Art. III, sec. 25(b)(2).

²⁷⁵ Exchange Act, secs. 15A(g)-(h) and 25.

The second principle is what has been customarily called "businessman's judgment" by association officials. It stems from the fundamental argument advanced for the Maloney Act; namely, that the need for raising the level of conduct in the over-the-counter securities business to a "highly professionalized plane" could best be met through ethical standards adopted and enforced by self-governing bodies of individuals actually engaged in the business rather than through increased and pervasive Government controls based upon rigid prescription. From this argument there have emerged two working principles: opposition to "legalisms" and avoidance of a "bureaucracy" (i.e., a large permanent paid staff). In practice, these principles have meant that when problems arise which require study and solution, a unit of volunteer members²⁷⁶ is created, or an existing one is called upon, to take over the task. If a problem concerns a particular segment of the industry, members from that segment usually compose the unit. Similarly, as the number of enforcement and disciplinary matters has grown, the services of more representatives from the business have been enlisted to cope with them. In general, new permanent staff personnel are employed or existing paid employees utilized only when the burden on members becomes so great that administrative assistance is required. Where responsibilities are delegated to the staff, a staff decision is usually subject to review by a member if a question of judgment is involved.

The third organizational principle is that of local autonomy. This principle is closely allied with the notion of "fair representation," which includes the protection of local and regional interests. It is reflected in the "district" system which has characterized the organization and functioning of the association from its beginning.²⁷⁷

b. The national organization and its functioning

(1) *The board of governors*

(a) *Election and composition.*—Charged under the bylaws with the "management and administration of the affairs of the corporation,"²⁷⁸ the board of governors has always occupied a preeminent position in NASD affairs. Each district committee selects a nominating committee (composed of nonmembers of the district committee), which in turn nominates the representatives of that district to the 21-man board of governors. Ten of the districts nominate one governor each. District 2 (California, Nevada, and Hawaii) and district 8 (Illinois, Indiana, Michigan, Wisconsin, Minnesota, and Iowa) each chooses three governors, and district 12 (New York, Connecticut, and northern New Jersey) chooses five governors.²⁷⁹ A governor serves for a 3-year term.

Selection by the nominating committee means automatic election unless additional candidates are nominated by a petition signed by 10

²⁷⁶ Technically, only firms are "members" of the association whereas national and district committees are composed of individuals associated with members.

²⁷⁷ See subsec. c, below.

²⁷⁸ Art. IV, sec. 2.

²⁷⁹ Hereafter in the text districts are identified by the city in which the district office is located. Tables XII-6 and XII-7 show the geographic arrangements of NASD districts prior to 1959 and subsequently. See subsec. c(2)(a), below, for a discussion of nomination and election procedures for district committees.

percent or more of the members in the district.²⁸⁰ A contested election arising out of such a petition has never occurred.²⁸¹

Adequate geographic representation was a primary concern of the framers of the Maloney Act. With few exceptions, local and regional interests appear to have been satisfied with the allocation of board seats,²⁸² and there has been only one adjustment in the association's history. In a redistricting that took place in 1959 one district was eliminated and the extra board seat was given to district 2.²⁸³

Although the scheme of the national organization is based primarily on geographic representation, the district nominating committees are to "endeavor, as nearly as practicable, to secure appropriate and fair representation on the board of governors of all classes and types of firms engaged in the investment banking and securities business."²⁸⁴ While NASD officials appear to have made an effort over the years to get more people from smaller firms to serve both at the district and national levels, they have had only limited success. One reason is that individuals in the one- or two-man firms simply cannot devote the time required for service on the board of governors. A second is that, with the three exceptions mentioned, each district can select only one governor every 3 years and the membership understandably tends to choose persons from the large, well-known firms as their national representatives. As a consequence individuals associated with large firms have predominated on the board.

The following table based on Questionnaire OTC-3²⁸⁵ and other data shows the relative predominance of large firms on the board:

TABLE XII-c.—Size of firms represented on the NASD board of governors in 1961

OTC volume (thousand dollars)	Number of firms on board	Total capital (thousand dollars)	Number of firms on board
<i>1961</i>		<i>1961</i>	
100,000 and over.....	5	10,000 and over.....	2
50,000 to 99,999.....	5	5,000 to 9,999.....	6
10,000 to 49,999.....	5	2,500 to 4,999.....	3
5,000 to 9,999.....	2	1,000 to 2,499.....	4
2,500 to 4,999.....	1	500 to 999.....	4
1,000 to 2,499.....	1	70 to 499.....	2
Total.....	19	Total.....	21

¹ Two firms did not report their over-the-counter volume for 1961; one of these was a mutual fund underwriter.

Sources: Questionnaire OTC-3; NASD records; Finance, Mar. 15, 1962.

Although NYSE member firms comprise less than 15 percent of the members of the NASD, they have usually held a majority of the 21 seats on the board of governors, as shown in the following table:

²⁸⁰ Bylaws, art. IV, secs. 12 (b) and (c).

²⁸¹ The nominating committee cannot nominate an incumbent board member to succeed himself without a majority vote of the entire membership in the district concerned. In recent years this has been done only where an individual has been appointed to complete an unexpired term of a governor who has resigned and the district desired to give the successor a full 3-year term.

²⁸² In a report of a special committee of the board to consider a resolution of one district requesting additional board representation, it was recommended that a study be made of the district boundaries and representation. The board concurred in the recommendations and the special committee was appointed which devised the 1959 districting plan. The plan was approved by the membership with a vote of 2,237 for and 64 against, with about 1,500 members not voting.

²⁸³ Compare tables XII-6 and XII-7.

²⁸⁴ Bylaws, art. IV, sec. 6(a).

²⁸⁵ See ch. VII and app. VII-B.

TABLE XII-d.—Number of representatives of NYSE member firms on NASD board of governors, 1957-63

	Number
1963.....	17
1962.....	13
1961.....	14
1960.....	10
1959.....	13
1958.....	11
1957.....	13

It should be noted that representatives of New York Stock Exchange firms serving as governors are ordinarily closer to general over-the-counter activity (including underwriting) than to the strictly exchange business of the firm.²⁸⁶

The composition of the 1961 board in terms of the principal activities of the firms with which its members were associated is summarized in the following table:

TABLE XII-e.—Activities of firms represented on NASD board of governors in 1961

[Number of firms]

	Primary activity	Secondary activity	Tertiary activity
Exchange commission.....	7	3	5
Underwriting.....	6	10	5
OTC retail.....	6	4	5
OTC wholesale.....	1	2	3
Other exchange.....		1	
"Financial services".....			1
Dealer or principal underwriter of mutual funds.....	1	1	1
Total.....	21	21	20

¹ Principal underwriter.

² One firm did not report a tertiary activity.

Sources: Questionnaire OTC-3 and NASD records.

This pattern has generally prevailed over the years.

The underwriting of mutual fund shares has been of increasing importance in the securities industry and a subject of extensive day-to-day regulation by the NASD. Nevertheless, it was not until 1960 that a representative of that group became a board member. At present (1963), no fund underwriter representative is on the board. About 30 percent (1,555 of 4,964) of the active firms responding to questionnaire OTC-3 sent to all registered broker-dealers stated that their primary business activity was mutual fund retail sales.²⁸⁷ Although two of the firms represented on the 1961 board reported that their secondary or tertiary activities consisted of mutual fund retail sales, none was primarily engaged in such activity.²⁸⁸

(b) *The board's duties and functions.*—As previously noted, the board is the center of responsibility and authority in the NASD. It has the duties of deciding association policy; promulgating (with the

²⁸⁶ NYSE member firms accounted for about 55 percent of the dollar volume of over-the-counter stock sales in 1961. See ch. VII.B and app. VII.A.

²⁸⁷ See ch. I, table I-10.

²⁸⁸ Since 1940 the board has annually appointed a national committee (the Investment Companies Committee) composed of underwriters of fund shares, which has been concerned with the investment company aspects of association business. See subsec. b(2)(e)(i), below. On a few occasions the association has had a national investment companies dealers committee, the most recent lasting from 1952 to 1954 when it was disbanded owing to lack of activity.

approval of the membership) the rules of the association; issuing interpretations of those rules;²⁸⁹ supervising the performance of its own committees, the district committees, and the executive staff in the administration and enforcement of board policies and association rules; and rendering final decisions in disciplinary proceedings on appeal or called up before it from the district business conduct committees.

The scope of those responsibilities is indicated in the minutes of board meetings. The minutes are fairly voluminous, typically containing (1) the reports of the executive director, of the board's 8 to 10 standing committees, and of any special committees appointed to study and report on particular problems (most governors serve on 1 or more committees); (2) a report of the chairman concerning his activities since the previous meeting; (3) the text of the decisions of the board in disciplinary matters and member continuance proceedings²⁹⁰ considered at the meeting; and (4) a detailed summary of its deliberations with regard to each of the reports and the disciplinary cases. Also, the newly elected chairman of the district committees attend the board's spring meetings and report orally on the activities of the respective districts.²⁹¹

It is apparent that the burden imposed upon the board is quite substantial, and it has become more and more so as a consequence of growth of the securities business and increased centralization of association activities in the national organization.

In setting standards, whether by declaration of policy, rulemaking, or otherwise, the board has from the beginning firmly held the reins of control. While the board has not always been as active in those areas as it might have been, the districts have had little authority to proceed independently. The board has placed increasing emphasis on national supervision and review of the district examination²⁹² programs, uniformity in rule interpretations and penalties, and conformity to national policy in district disciplinary proceedings.²⁹³

The term of a governor is 3 years, with a one-third turnover in the membership every year.²⁹⁴ Since the board ordinarily meets only three times a year for 3 days at a time, there are limitations of time and continuity on the board's ability to perform its job. Despite the increase in the workload, the board has been reluctant to reduce its responsibility for enforcement. In fact, control over enforcement, particularly

²⁸⁹ Procedures for adoption of association rules and rule amendments are set forth in the bylaws, art. IX.

²⁹⁰ Sec. 15A(b) of the Exchange Act and art. I, sec. 2, of the NASD bylaws provide that, except where the Commission finds it appropriate in the public interest to approve or direct to the contrary, no broker may be admitted to or continued in membership if he, or any controlling or controlled person, is under any of the several disqualifications specified in the statute or the bylaws. A Commission order approving or directing admission to or continuance in association membership, notwithstanding a disqualification under sec. 15A(b)(4) of the act, or under an association rule under that section or sec. 15A(b)(3), is ordinarily entered only after the matter had been submitted to the association by the member or applicant for membership. District committees are charged with initial responsibility in this area, but the final NASD recommendation to the Commission is made by the board. See ch. II and pt. I, below.

²⁹¹ The district chairmen form the "advisory council" which is provided for in the bylaws, art. IV, sec. 16.

²⁹² "Examination" is the term used by the association for its inspections of the books, records, and business procedures of member firms and branch offices. This should be distinguished from the qualifications examination for registration of a representative discussed in ch. II. Unless otherwise indicated the term is used in this part of the present chapter in the former sense. The examination program is discussed in sec. 5.a, below.

²⁹³ See subsec. b.2.(b), below.

²⁹⁴ Bylaws, art. IV, sec. 4.

through review of disciplinary cases, has become its dominant activity, at the expense of its role of policy formulation. Concern over this development was expressed at a recent board meeting:

Mr. Rockefeller [chairman of the board] concluded his opening remarks by pointing out that the number of business conduct matters has grown to the point where the cases occupy most of the board's attention, leaving only a limited amount of time for discussion of policy matters. He stated that either some greater authority must be passed on to the National Business Conduct Committee to handle disciplinary cases or the board may have to meet more frequently, or both.

Despite the efforts which the board has made to cope with the increased volume of disciplinary matters, there seems little likelihood of success without a raising of entry standards (see ch. II) and/or a change in the association's methods. Lengthening the term of office of the governors in order to provide continuity and experience does not appear to be a solution. As a general rule, a member of the board has, by the time his term of office expires, already served the association for 6 years—3 years on a district committee and 3 years on the board, including service on one or more board committees or district subcommittees—and he may well be called upon subsequently to contribute further time and effort in various capacities. It also may not be practical for the full board to meet more frequently than at present, in view of both the difficulty of assembling 21 busy men from all parts of the country and the fact that several weeks of work by most of the board committees and the executive staff are required to prepare for each meeting.²⁹⁵

(2) *The standing committees of the board of governors*

(a) *Executive and finance committees.*—An executive committee has been chosen each year since the beginning of the NASD. It currently consists of nine governors and the executive director, and its chairman has customarily been the chairman of the board. This committee is the only one specifically provided for in the association's bylaws which state:

By resolution passed by a majority of the board of governors, there may be created an executive committee, consisting of five or more members of the board, which committee shall have and may exercise such powers of the board in the management of the business and affairs of the corporation in the interim between meetings of the board of governors as may be delegated to it from time to time by the board; provided, however, that any action of a disciplinary nature by an executive committee created hereunder, which affects the business or standing of any member of the corporation, shall become binding only after approval by the board of governors.²⁹⁶

In general, the committee meets at about the same time and place as the full board. It also meets each spring with the finance committee to consider the budget and the dues and assessments schedule for the next fiscal year.²⁹⁷ Other "meetings" are held by mail or telephone.²⁹⁸

²⁹⁵ In order to alleviate the backlog of disciplinary cases, special meetings of the board and the National Business Conduct Committee were held in December 1962.

²⁹⁶ Bylaws, art. VI, sec. 5.

²⁹⁷ The association's fiscal year begins on Oct. 1.

The finance committee is composed of about six or seven governors and the executive director. Several of its members are also on the executive committee. Aside from its joint meetings with the executive committee, the finance committee has on occasion "met" by mail to consider supplemental appropriations for such items as increases in staff, salaries, and purchases of office equipment by the national and district offices.

²⁹⁸ From time to time circumstances have necessitated special face-to-face meetings. For example, in November 1961 the committee met with the Commission to discuss implementation of the board's decision to enter the field of underwriters' compensation. See subsec. b(2)(e)(iv) and sec. 5(b)(3), below.

Over the past few years, the executive committee's duties have grown, particularly in the areas of rulemaking and interpretation and supervision of district enforcement activities. When time has not permitted the full board to act, the executive committee has often assumed the initiative and occasionally the ultimate responsibility for association action on such issues as pending legislative proposals, contemplated Commission rules, and NASD intervention or participation in court proceedings. The executive committee's participation in policy planning has been mainly confined to consideration of studies and recommendations for association action originated by others and to carrying out policy determinations of the board.

The committee's capacity to take on a greater share of policy planning is severely limited by its preoccupation with administrative detail.²⁹⁹ Many of the matters with which the committee has been concerned have related to fiscal administration (and as a result have on occasion been the subject of a joint meeting with the finance committee).³⁰⁰ Another administrative matter which has been frequently before the executive committee (particularly since 1958) is whether to send out "free-riding" questionnaires to underwriting and selling group members in particular offerings.³⁰¹ It has sometimes been necessary for the executive director to obtain the necessary authorization to send out questionnaires by telephoning committee members or mailing ballots to them. There may have been reasons for having the committees make individual determinations in the early stages of enforcing the free-riding policy, but there appears to be far less justification for that procedure after enforcement policy has been formulated and the use of the questionnaires has become a regular enforcement tool.

(b) *National Business Conduct Committee.*—The National Business Conduct Committee is probably the most active in the association. It is chosen annually by the board and normally has about 9 or 10 members, all of whom are governors. Half of its members are replaced each year and no member normally serves more than 2 years.

The primary function of this committee is to oversee disciplinary proceedings at the district level to insure compliance with the association's bylaws, rules, and policies. In the work of the committee one can observe almost the entire range of the NASD disciplinary process. All decisions of the district business conduct committees are reviewed by the committee, which is vested with the power to call up cases for board consideration. It also reviews cases appealed by members to the board. If the committee deems it necessary to hold a hearing or

²⁹⁹ Examples of some of the items of business which the committee, on numerous occasions, has had to pass upon are (1) granting permission to respondents to pay in installments fines and costs assessed against them in disciplinary proceedings, regardless of the amount involved; (2) approving salary increases for staff members from clerks and stenographers to district secretaries, often amounting to as little as a few hundred dollars; (3) approving the purchase by a district office of office equipment; (4) authorizing the hiring of additional personnel including clerks and stenographers; and (5) approving contributions ranging from a few hundred to a few thousand dollars to other institutions for various educational projects.

³⁰⁰ See sec. 4, below.

³⁰¹ Under an interpretation of its rules of fair practice requiring that members observe "high standards of commercial honor and just and equitable principles of trade" (art. III, sec. 1), the NASD has stated that it is a violation of that rule for any member, directly or indirectly, to withhold any portion of a public offering in its own account or in the accounts of persons affiliated with it. Securities taken for investment if not disproportionate or substantial are exempted from the interpretation. See ch. IV.B.3 and sec. 5.b(2), below. NASD manual (manual), G-23-31. The NASD has primarily relied upon the use of questionnaires to enforce the "free-riding" policy.

if one is requested by a member, it appoints a panel to conduct the hearing. The committee makes a recommendation as to the disposition of each case called up before or appealed to the board which is then reviewed and acted upon by the full board.

The great increase in the workload of the National Business Conduct Committee is summarized in the following table:³⁰²

TABLE XII-f.—Number of disciplinary proceedings reviewed by the National Business Conduct Committee, 1939-62

Year	Number of complaints filed	Number of decisions appealed	Number of cases called up	Total board of governors cases
1962.....	452	75	40	115
1961.....	422	46	34	80
1960.....	343	34	34	68
1959.....	260	37	¹ 50	87
1958.....	206	25	5	30
1957.....	137	26	13	39
1956.....	130	21	6	27
1955.....	125	10	5	15
1939-54.....	625	68	116	184

¹ A large percentage of these cases involved similar charges and the committee called them up to enable the board to enunciate a uniform association policy in that type of case.

Source: NASD records.

The heavy volume of cases reviewed results both from the larger number of proceedings and the desire to obtain uniformity in enforcement policy. The committee (and the board) has had to devote considerable attention to the task of maintaining uniformity in rule applications and penalties imposed in the 13 districts.³⁰³

The National Business Conduct Committee has sought to lessen its burden and provide a measure of continuity in personnel and policy by placing reliance on full-time counsel³⁰⁴ and by the increased use of hearing panels³⁰⁵ composed of a governor as chairman and one or two former governors, all preferably residing in the vicinity of the district concerned. The hearings on cases appealed or called

³⁰² In reporting to members on its 1959 work the committee stated:

"This leads us to the question of the ever-increasing number of complaints, hearings, appeals, and reviews. These procedures are time-consuming for volunteers in the business whose own affairs at this juncture are more than full time, to say the least. But, we believe the time and effort expended is fully justified and will advance the purpose of the association." (NASD Annual Report, 1959.)

³⁰³ Recently, the board addressed a letter to a district committee chairman which read in part as follows:

"Of further and growing concern to the board in its review of the situation, has been the method and approach of the district * * * in handling disciplinary matters. Indications are that in certain instances the attitude of the district business conduct committee for district * * * has differed from that of other districts. The board fully appreciates that this particular problem may be due in large extent to administrative difficulties but feels that these should not be allowed to have any influence on matters of substance * * *.

"The attainment of the objectives of uniformity and fairness depend to a great extent on the time and effort expended, not only by members of the board of governors, but also by the members of the district business conduct committees. It is essential that they make the necessary sacrifice of their time to permit the fulfillment of their duties. It is recognized that the committee members, as well as the members of the board, serve as volunteers: nonetheless they must be prepared to devote the necessary time to the important work of the association * * *.

"It is the wish of the board that you, as incoming chairman, review with your committee the operations and procedures of the committee, not only to insure proper operation of your district but also in order that we may move forward and come closer to these ideals."

³⁰⁴ See subsec. b(4)(a), below.

³⁰⁵ In January 1958, the committee recommended and the board adopted a procedure whereby former governors who had served on the board within the preceding 2 years were permitted to serve on hearing panels. However, it was not long before this appeared inadequate to provide the requisite personnel, and in September 1958 the board increased the eligibility period for ex-governors to 5 years.

up are frequently de novo hearings in whole or in part and can be time consuming.³⁰⁶

(c) *Legislation committee.*—The legislation committee, which is normally composed of three or four governors, participates in the formulation of the association's official position regarding pending or contemplated legislation and represents the association with respect to legislative matters. Its work on such matters may overlap with that of the executive committee and other standing committees.

This committee's function is more in the nature of lobbying than regulation. Its activity is directly proportionate to the activity of the Commission, the Congress, and other agencies in advancing legislative or regulatory proposals which may have an impact on the securities business generally.

(d) *Information committee.*—The information committee has responsibility for the public relations activities of the association.³⁰⁷ It is composed of three or four governors and the executive director, but it relies chiefly on the services of an outside public relations consultant. The committee supervises the publication of several different kinds of materials on the work of the NASD, including annual reports, the NASD News,³⁰⁸ and news releases relating to the annual selection of national and district officials and to disciplinary proceedings involving expulsions from membership.³⁰⁹ It is also responsible for the efforts in recent years to obtain publicity concerning the over-the-counter markets.

Popular recognition of the association lags far behind that of other regulatory and official self-regulatory bodies. There are several reasons for the comparative anonymity of the NASD. In the first place members have been greatly restricted in their ability to advertise the fact of their association membership. A board resolution adopted in 1954 prohibits the use of the association's name in connection with the promotion or sale of any specific security or type of security.³¹⁰ The prohibition extends to letterheads and confirmations as well as market letters and other selling materials. The member is, as a practical matter, free to advertise his membership only on his office door or by hanging a membership certificate on the wall. The view of the association has been stated as follows:

It will be a long time before some firms agree to identification with any outfit; there are others with, perhaps, a different sort of pride who are not unwilling to turn a proper connection to fair business advantage, all things being equal. There are still others who would join anything if they could generate a piece of business by so doing.

Well, the association is open to all comers so all shades of taste can show up in how to go before the public in "ads." And of late the public manners of a few are what might be called brisk. The association name gets linked, in one way or another, with some effervescence not commonly identified with accepted standards of advertising securities.³¹¹

Secondly, the association, which as a result of the 1954 resolution is the principal source of public information about itself, spends rela-

³⁰⁶ See code of procedure for handling trade practice complaints, secs. 15, 16, and 21(a).

³⁰⁷ At times in the past the functions of this committee were performed by a "public relations committee" (or "member relations committee," as it was at one time called) and a separate "education committee."

³⁰⁸ The NASD News is published about three times a year.

³⁰⁹ See sec. 6, below.

³¹⁰ Manual, H-10-11.

³¹¹ NASD News, April 1954.

tively little money on publicizing its activities.³¹² Thirdly, limited publicity is given to the results of its disciplinary proceedings.³¹³

The other main duty of the information committee, that of promoting the over-the-counter markets, has, in marked contrast to similar activities of the New York Stock Exchange, been a very limited one. The committee has placed some emphasis on persuading newspapers, financial publications, and other media to publish general news and feature articles about the over-the-counter markets, but it has avoided sponsorship of the "Invest in America" type of promotion. The association's view on that subject is illustrated by the following excerpt from the NASD News of September 1951:

Considerable discussion took place at the last meeting of the board on the subject of "Invest in America" campaigns. Before the board was a suggestion that the association take an active role in the national promotion of such campaigns. It stirred up an interesting debate in which nearly everyone in the room took part.

No one was against the "Invest in America" idea. On the contrary. But what some of the governors were worried about was the possibility that such campaigns might become too prominently identified with the securities business. One cautioning comment went something like this: "Let's be careful we don't appear to be 'fronting' for campaigns to get people to buy stocks. We found ourselves in that position once. Let's be sure it doesn't happen again."

There were other comments in the same vein—governors wanting to support a constructive and wholesome endeavor but wary about the position the business could place itself in.

Upshot of it was that there was more or less unanimous agreement that the association certainly favored local efforts to spread knowledge of investment and saving, where people in the securities business were cooperating with groups of industrial and commercial organizations, providing technical information and literature and speakers and the like.

Governors wanted no part of such efforts where the securities business went it alone or led the movement.

This has been the consistent position of the committee and the board.

(e) *The standing committees on substantive matters.*—In view of the board's intensive preoccupation with enforcement and disciplinary matters, much of the initiative in the realm of substantive policy over the years has been placed in the hands of volunteer member committees composed for the most part of nongovernors who are usually specialists in specific aspects of the securities business. These committees may also have administrative functions and the more important in effect have their own staffs for the purpose of carrying out their duties. The committees possess a large degree of autonomy in both their policy and administrative responsibilities.

(i) *Investment Companies Committee.*—The Investment Companies Committee has been principally concerned with the handling, subject to board control, of NASD administration and policymaking in the field of mutual fund underwriting and distribution. It also exercises surveillance over the association's enforcement of the Commission's Statement of Policy³¹⁴ and the association's investment trust rule.³¹⁵

³¹² Public relations expenditures for the fiscal years 1959–61 were \$19,666, \$20,021, and \$21,665, respectively. See pt. B, above, with regard to public relations and similar activities of the NYSE.

³¹³ See sec. 5.e(3), below.

³¹⁴ Administration of the Statement of Policy is discussed in subsec. b(4)(c) and sec. 5(b)(1), below, and ch. XI.B.

³¹⁵ This rule, sec. 26 of the Rules of Fair Practice, was adopted pursuant to authority granted under sec. 22 of the Investment Company Act of 1940 and essentially establishes certain standards governing member transactions in securities of open end investment companies. Among other things, it establishes "net asset value" as the minimum price a member must pay for mutual fund shares purchased from an issuer.

Since the early years of the NASD, this committee has been composed primarily of members from the mutual fund underwriting segment of the industry. At various times there has been some dealer representation but in about 1950 it became exclusively an underwriter-sponsor group. Recently, two men from the contractual plan sponsor group became members of the committee. The exclusion of dealers, whose interests have not always coincided with those of the underwriters, apparently came about because the underwriters wanted a forum where they could candidly discuss their own problems.

An attempt is made to preserve continuity in the committee's membership by often having the chairman and other committee members serve from year to year. There are seven members at present, none of whom is a governor. Like other specialized standing committees, the Investment Companies Committee is in many ways semiautonomous. It has its own paid staff, the Investment Companies Department of the NASD, and it formulates the budget requests not only for itself but for the department. The committee's handling of reciprocal business practices in the allocation of brokerage commissions by mutual funds shows interestingly the relationships among the board, the committee, and the permanent staff.³¹⁶

As early as 1949, the National Association of Securities Administrators (NASA), an organization of State securities administrators, adopted a resolution which read as follows:

Resolved, That the association looks with disfavor upon any attempt to promote the sale of investment company shares by agreeing to give dealers, either directly or indirectly, in addition to the usual contractual allowances, any amount of brokerage business, and that such promises shall be deemed to be prima facie evidence of an unfair business practice and not consistent with sound management of the fund.

In 1952, that resolution was supplemented to express the view of NASA and others that "give-ups" of commission or profits on portfolio transactions executed for investment companies in the over-the-counter markets should be prohibited whether or not agreements were involved. The Investment Companies Committee, with the knowledge of the board, participated in the formulation of the 1952 resolutions and supported their adoption; and an article describing the NASA position appeared in the NASD News.³¹⁷

The committee did not begin to take official cognizance of the matter with a view to possible association action until almost 5 years later. In its January 1957 report to the board, the committee stated:

Another matter that appears to be of increasing concern, as to which this committee would like action by the board at this meeting involves the question of the propriety of various arrangements for passing along to dealers credit for stock exchange business resulting from portfolio transactions.

Of course, this is a matter of considerable delicacy and some controversy. It always has been a matter of concern within the investment company branch of the business, as well as to responsible dealers. * * *

It would seem appropriate that the NASD, having definite enforcement authority as to underwriters and dealers, might well act in this area by sponsoring its own statement of policy or statement of principles to cover such transactions.

It is our strong feeling that this is an area in which this association properly may consider means of bringing order and propriety into this situation. The

³¹⁶ See also the discussion in ch. XI.C.

³¹⁷ NASD News, March 1953.

Investment Companies Committee, therefore, respectfully requests authority from the board of governors at this time to initiate a study in this area with the goal of drafting a recommended code of fair or proper procedures for presentation to the board for adoption at the May meeting, or as soon as possible thereafter.

Board authority for the study and recommended code was immediately granted.

No formal report was submitted by the committee to the board at its May 1957 meeting. The executive director merely noted in his report that the "Investment Companies Committee is continuing its studies of discount pricing, reciprocal business, and late payment for shares, as directed by the board."

At the September 1957 board meeting the committee reported:

In accordance with the authority granted by the board at the January 1957 board meeting, we are continuing our studies in this area. * * * We had hoped to come up with recommendations for a code of fair or proper procedures that would be effective in this situation in time for consideration at the May or September meetings of the board. However, this has not been possible, and we are unable to forecast just when we can complete this investigation.

It would appear that there were no formal studies in progress between January and September 1957.

The committee's report to the board in January 1958 referred to reciprocal business in the following way:

This is one of the most difficult and far-reaching problems before the committee. It is one which we voluntarily sought to explore with a view to finding a constructive solution, and we are pursuing the matter under the authority granted us by the board. The problem involves many different elements of the securities business, and since the committee has had many other matters on which immediate action has been required, it simply has not been able to give the question of reciprocal business the careful and thoughtful deliberation so important a subject requires. It certainly does not wish to make recommendations until there has been further opportunity to study the matter. Now that some of the more immediate matters that have required action by the committee have been or are in the process of being resolved, the committee plans to give this matter the detailed consideration it merits.

The board, apparently for the first time, then determined that it might not be the most desirable course to leave the issue solely in the hands of the Investment Companies Committee. It directed that a staff study be made and authorized the chairman to form a special committee to consider the matter. As already observed, the firms represented on the board were, with respect to their activities connected with mutual fund sales, largely in the dealer category (i.e., potential recipients of reciprocal commission business); and there was at that time no underwriter board member. The Investment Companies Committee was to continue its work on the matter.

Following the January 1958 meeting, the staff undertook to develop plans for a broad survey of the membership relating to reciprocal business generally. It was to include but not be limited to reciprocal brokerage in connection with the offering of mutual fund shares. The chairman of the Investment Companies Committee argued that the survey approach not be used or at least be deferred and that detailed proposals for dealing with the problem be prepared. At least partly because of the announcement by the Commission of its contemplated investment-company-size study, it was his view that immediate action should be taken by the NASD to "strengthen the industry's position."

The survey approach was deferred and the committee finally presented proposals to the board in September 1958.

Subsequent association efforts concerning reciprocal business are considered in chapter XI.³¹⁸ It should be noted at this point that the committee had been aware of the problem for many years before taking its first real steps to meet it. Between 1952 and 1957 the permanent staff was not asked to take the matter of reciprocal business under study or even to prepare a preliminary analysis of the question for consideration by the committee or its chairman.

(ii) *National Quotations Committee*.—The National Quotations Committee is one of the oldest in the association. It generally has been composed of about nine members who, for the most part, have experience and managerial responsibilities in the trading departments of their firms. Occasionally a governor serves on the committee. Here again an effort is made to obtain continuity by having the chairman and most members serve for a period of years.

The committee was created shortly after the formation of the NASD in response to a Commission request that the association take over the gathering and distribution of retail newspaper quotations.³¹⁹ Immediately thereafter, quotations committees were created in nearly all of the districts and local quotations committees were set up in the various market centers.

Local listings supplied by local committees constituted the only form of retail quotations sponsored by the association until 1956, when the national and regional lists were established. Aside from the broad standards first laid down by the committee in 1941 (and subsequently revised) on the size of spreads, the numerous local committees and their respective lists were under virtually no national control until 1962. In that year the board of governors authorized the establishment of machinery for conducting supervision and review by the national office.

Until the establishment of the national list, the committee's work consisted almost entirely of coordinating local efforts and prompting NASD sponsorship of newspaper quotations. This has continued to be one of its major functions. The committee has attempted to persuade dealers sponsoring retail quotations to permit the NASD local committees to take over the task.³²⁰ The NASD has considered private dealer bylines for local quotations a form of unfair competition. In 1959, a formal association policy favoring NASD sponsorship was adopted.³²¹ By the end of 1961, about 3,000 over-the-counter issues were quoted by the NASD.

The committee has been less successful in policing the accuracy and adequacy of local retail quotations and individual committee listing and pricing standards. No concrete steps to bring the system under central control were undertaken until the national and regional lists were established, and no national program to review local practices not preempted by the establishment of those lists was created until 1962.³²²

³¹⁸ Ch. XI.C.3.b.

³¹⁹ See the discussion of the operation of the retail quotations system in ch. VII.D.4.

³²⁰ Association officials have from time to time expressed doubt as to whether the NASD is empowered under the Exchange Act to require its members to give up their own quotations in favor of NASD sponsorship. See S. 1642, 88th Cong., 1st sess. (1963).

³²¹ Manual, G-53-4; NASD News, April 1959.

³²² See the recommendations in ch. VII with respect to retail quotations.

The establishment of the national list created a need for a paid staff. Previously, the committee had relied on its own membership and the district staffs for carrying out its goal of obtaining universal NASD sponsorship. By the end of 1961 it had a paid staff of five. It does not appear that the staff exercises or is expected to exercise any substantial initiative in ascertaining, analyzing, or recommending methods of dealing with broad problems relating to quotations. In fact, the committee secretary spends a substantial amount of time on various other matters.³²³

(iii) *Uniform Practice and foreign Securities Committees.*—The Uniform Practice Committee has about six members who generally have experience and managerial duties in their firms' back offices and are not members of the board. There tends to be continuity of personnel on the committee.

The committee stated at the outset that:

* * * the existing variations in standards [governing the technical details of trading, delivery of securities, ex-dividend dates, closeout procedures and computation of interest, when-issued trading, and similar matters] result from the fact that each trading area in the country evolved its own customs through the years on the basis of usage, convenience and other factors. At present, trading between different localities, and sometimes within one locality, often gives rise to disputes and misunderstandings. National standards will place all trading on a clearly defined basis and eliminate possible friction at its source.³²⁴

In 1941, the uniform practice code, which has since been amended several times, was formally adopted. The business of the committee has consisted largely of settling disputes between members under the code, issuing formal announcements to members calling their attention to trading practices and problems of current significance, and, if feasible, suggesting methods of dealing with them. It has considerable independence in carrying out those functions.

The demands on committee members have in recent years caused its staff to assume a greater role. The committee secretary at present handles most of the disputes among and complaints of the members. Except where novel questions arise, the committee is almost never consulted. Both committee members and association members have apparently developed considerable respect for the ability and judgment of the secretary in controversies involving the highly technical rules embodied in the uniform practice code.³²⁵

Committee (and association) performance in handling the problem of "fails" has been less satisfactory. This problem and the limitations of the uniform practice code in dealing with it are discussed in chapter III. Until the creation of the National OTC Clearing Corporation in 1962, the association's approach consisted largely of educational efforts and campaigns of persuasion to convince the brokerage community to expedite the physical handling of securities and to utilize the provisions of the code, such as the noncompulsory "buy-in" procedure.

³²³ The secretary also serves as special assistant to the executive director. In this capacity he has charge of administering the association's registered representative examination and qualification program, developing topics to be covered by the executive director and the chairman of the board at their meetings with district committeemen, and revising and updating the course used for training association examiners.

³²⁴ NASD News, Nov. 9, 1940.

³²⁵ During the latter part of 1962, the committee secretary resigned his post to become full-time secretary and treasurer of the National OTC Clearing Corporation.

The work of the Foreign Securities Committee, which is largely composed of nongovernor members associated with firms doing a substantial foreign business, broadly parallels that of the Uniform Practice Committee. In fact, both committees share the same committee secretary. As with the Uniform Practice Committee, the staff answers inquiries and renders "rulings" and opinions on the technical details and procedures of trading in foreign securities.

(iv) *Committee on Underwriting Arrangements.*—This committee was established in December 1961, primarily for the purpose of reviewing and commenting upon preliminary prospectuses and offering circulars in order to determine whether the underwriters' compensation arrangements are reasonable.³²⁶

While it has been called a "special" committee, its duties are more like those of a standing committee. The committee consists of six members, two of whom are governors. Since there are as yet no standards of conduct in this field beyond those of "fairness" or "reasonableness,"³²⁷ the function of formulating policy may prove to be highly significant. Staff assistance has been provided for the purpose of preliminary screening of prospectuses and offering circulars. The committee itself does not clear every prospectus. Cases in which the contemplated compensation is clearly within the bounds of fairness are not referred to the committee. The committee has, in the initial phase of this program, set forth certain rules of thumb for the guidance of the staff. The fact that the national staff enters the investigative process at an early stage should insure a certain degree of uniformity in the application of standards.³²⁸ This has been true of the association's administration of the Statement of Policy under the Investment Company Act.³²⁹ The Committee on Underwriting Arrangements has, however, unlike the Investment Companies Committee, retained the sole power to communicate to members the association's official position with respect to compliance with the applicable standards.³³⁰

Between December 1961 and September 1962, the committee held 26 meetings of approximately 3 hours each and reviewed more than 1,200 offerings. It may be hoped that the association's entry into this field will itself reduce the number of questionable cases requiring committee action. However, in the event of recurrence of the new issue phenomenon it is unlikely that the committee as presently organized will be able to perform its responsibilities adequately.

(v) *Trading Committee.*—The five members of this committee are traders or trading supervisors for their firms. Its first chairman was a governor but he has been the only board member to serve on the committee.

The committee was set up by the board in 1959 in response to a Commission proposal to amend its stabilization rules and expressions of Commission concern with misuse of the National Daily Quotation

³²⁶ It was also intended to furnish guidance to participants in an underwriting with respect to the application of that part of the board's free-riding and withholding interpretation covering sales to persons not normally considered public purchasers. NASD annual report, 1961. See the discussion in pt. I, below, and in ch. IV.B, concerning the background of NASD action in the area of underwriter's compensation. See also sec. 5.b.3, below.

³²⁷ See Manual, G-59-62.

³²⁸ See the recommendations in ch. IV.B with respect to the publication of rulings on underwriting arrangements.

³²⁹ For discussions of NASD administration of the Statement of Policy see ch. XI.B, sec. 3.b(4)(c), and sec. 5.b(1), below.

³³⁰ The present procedures provide for the executive director to sign letters of comment on behalf of the committee. One reason for that is the desire to preserve the anonymity of the persons serving on the committee.

Service sheets and "boiler room" operations. After meeting in January 1960 to discuss these problems with the staff of the Commission, the committee recommended that the association take the action the Commission requested on quotations and "boiler room" problems.

As a result, the board adopted an interpretation of the provisions in the NASD rules of fair practice, which broadly prohibits (1) dissemination of quotations not believed to be bona fide, and (2) manipulative and deceptive acts, to make it clear that use of spurious quotations may violate both provisions;³³¹ and a letter was directed to members soliciting their cooperation in detecting boiler rooms and communicating relevant information to the national office for possible forwarding to the Commission.

In May 1960, the committee reported continuation of its work with the Commission staff on the proposed stabilization rules and that it had reviewed and submitted revisions to the "Over-the-Counter Trading Handbook" prepared by the NASD staff.³³² At the January 1961 meeting the committee did not submit a written report, but the chairman told the board: "We have been very fortunate and had no problems." No Trading Committee was selected by the board for 1963.

(3) *The officers of the association*

The officers of the association are the chairman of the board of governors, two vice chairmen, the treasurer, and the executive director.³³³ They are chosen annually by a nominating committee customarily composed of the seven outgoing members of the board and approved by the new board at its first meeting. Their terms of office are for 1 year, and only the executive director receives compensation. The vice chairmen of the board preside in the absence of the chairman.

(a) *Chairman of the board.*—The chairman is traditionally a third-year member of the board. His authority is roughly comparable to that of a corporate board chairman.³³⁴ He is the principal spokesman for the association before Congress and other public bodies. He annually visits the districts, accompanied by the executive director, to acquaint himself with local problems and to advise the district committees on association policy. It has been estimated that the 1962 chairman devoted about 80 percent of his time to association affairs.

Although the growth of the securities industry and the concomitant growth of NASD functions and influence have made the chairman's job an increasingly important one, his ability to supply leadership has been limited. This is not due to any lack of diligence or competence on the part of those who have served as chairman. It appears to be a result of the amount of time consumed by the board on enforcement responsibilities³³⁵ and the shortness of the chairman's term of office. He thus has little opportunity to consider broad substantive problems, although some chairmen have made a very substantial effort in that direction.

(b) *Executive director.*—Prior to the founding of the association, it was not anticipated that the executive director would occupy an important position in the policymaking area. At that time, there was

³³¹ Manual, G-54.

³³² This booklet published by the association summarizes some of the established trading practices in the over-the-counter markets and seeks to explain common trading terms, symbols, and abbreviations in general use. See ch. VII.

³³³ Bylaws, art. V, secs. 1-2.

³³⁴ Bylaws, art. V, sec. 2.

³³⁵ See subsec. b(1)(b), above.

active discussion between industry members and the Commission on the extent of staff participation in the association's affairs generally.³³⁶ Many persons at the Commission favored a strong staff with a full-time chief executive endowed with extensive authority. The industry vigorously opposed that idea. The outcome was the present permissive provisions of the bylaws:

The board of governors may elect a chief executive officer and such other executive or administrative officers as it shall deem necessary or advisable, whose terms of office shall be at the pleasure of the board of governors, and of the officers so elected, one shall perform the usual duties of a secretary of a corporation. All such officers shall have such titles, such powers and duties and shall be entitled to such compensation as shall be determined from time to time by the board of governors, and in addition shall perform the usual duties of such officers of a corporation. The board of governors, by affirmative vote of 11 members, may remove any such officer at any time.³³⁷

The board created the office of executive director and gave it, at least formally, the powers "customarily incident to the office of a president of a corporation." Since the office was created the board has looked to the executive director primarily for administrative direction, not policy initiative. Although the executive director is a nonvoting member of the executive, information, and finance committees, he is not a member of the board and he serves without a formal employment contract.

Wallace H. Fulton, who has served as executive director since 1939, has made many important contributions to the advancement of the basic aims of the association. He has sought to reduce the disciplinary workload of the board and the national committees through increased administrative controls over the district enforcement machinery. He has initiated various programs to acquaint district committeemen with national policies concerning disciplinary proceedings. He has spent much time traveling throughout the country in order to talk to committeemen, association members, and district staffs about NASD national policy and objectives. Despite these efforts, he has not had the time or the staff assistance needed to improve significantly regional conformity to national policy.³³⁸

Although never considered the chief spokesman for the association, the executive director has done much to "sell" the idea of industry self-government to the industry and the public. He has frequently addressed meetings and conventions of industry and regulatory authorities concerning the objectives and accomplishments of the NASD. He has also provided the initiative for such limited steps as the NASD has taken toward providing a regular flow of data about the over-the-counter markets.³³⁹ In addition, the exec-

³³⁶ At about the same time the NYSE had issued the Conway report recommending an adequate staff headed by a chief executive for that exchange. See pt. B.2.a, above.

³³⁷ Bylaws, art. V, sec. 2. In approving the association's registration, the Commission expressed the opinion that a "chief executive endowed with sufficient powers" would be required (5 S.E.C. 627, 628 (1939)). See sec. 2.a, above.

³³⁸ See, e.g., subsec. b(4)(b), below.

³³⁹ In 1949 the NASD sponsored a study by the Wharton School of the University of Pennsylvania of the over-the-counter markets. See Friend, Hoffman & Winn, "The Over-the-Counter Securities Markets" (1958). Since the Wharton School report was based upon data assembled before the recent phenomenal growth of the market, the executive director recommended that the board sponsor a further study. When the project was first presented for formal approval in 1959, the board declined to act. Following the enactment of legislation authorizing the study, the board followed the executive director's recommendation.

utive director has taken the lead in NASD efforts to upgrade entry standards.

Located in Washington, the executive director frequently meets with the Commission and its staff. Such communications between the self-regulatory and regulatory agency are of great importance under the statutory scheme and have apparently been more continuously maintained by the NASD than by any other self-regulatory agency. However, to the extent that this has been a source of positive regulatory accomplishment in dealing with broad problems of the over-the-counter markets, it has generally taken the form of NASD reaction and response to proposed Commission action as distinguished from the taking of initiative by the association. In general, the executive director is apparently not expected to come forward routinely with programs for future association action.³⁴⁰

A major part of Mr. Fulton's accomplishments are due to the respect which has gradually developed for his ability and dedication during his long incumbency, rather than the authority vested in the office itself. It was recently announced that Mr. Fulton will retire on April 1, 1964, and it cannot be assumed that his successor will be able to supplement the limited authority of office with his own prestige. Under the circumstances, it may well be desirable to grant formally to the executive director's office broader responsibility and influence in policy, program, enforcement, and disciplinary matters and greater authority over the entire staff. It may also be desirable to give the executive director some tenure, so as to allow him a greater degree of freedom to exercise initiative and leadership.³⁴¹

(c) *Treasurer*.—The position of treasurer is largely honorary. Aside from the fact that the treasurer is customarily one of the governors serving on the executive and finance committees, he exercises no formal fiscal authority during his 1-year term except to review and sign his three reports to the board. These reports (as well as those of the finance committee) are prepared by the comptroller, who handles most of the administrative matters concerning finance.

(4) *The national executive staff*

The growth of the association staff has been steady but it has not kept pace with the increased responsibilities imposed upon the NASD.³⁴² In 1940, there were, in addition to the executive director, 10 national staff members; in 1951 there were 23; and in 1962 there were 80.³⁴³ In practice, the NASD long ago abandoned the notion that it would operate essentially without a "bureaucracy,"³⁴⁴ and the realistic question today is what kind and how large a staff is essential to enable it to carry out its proper functions.

The following discussion is concerned with the functions of the three departments of the national staff and the office of counsel.³⁴⁵

³⁴⁰ See pt. I, below.

³⁴¹ The presidents of the New York, American, and Midwest Stock Exchanges have employment contracts. See pts. B, C, and D, above.

³⁴² See table XII-8.

³⁴³ At the end of 1962, the association had a total of about 160 staff members.

³⁴⁴ The executive director stated in 1951:

"It has always been my desire to keep the administrative staff as small as possible—to control costs and to insure absence of anything smacking of bureaucracy." NASD News, September 1951.

³⁴⁵ The functions of the secretaries of the National Quotations and Uniform Practice Committees who serve on the national staff have already been discussed in subsec. b(2), above. See sec. 4 for a discussion of the comptroller's role.

(a) *Counsel to the association.*—Except for the executive director, no staff official has greater responsibility and authority in the regulatory phases of the association's work than its counsel.³⁴⁶ His principal duty is to review all district committee disciplinary decisions for the National Business Conduct Committee. He makes recommendations to the committee as to whether it should exercise its call-up authority and he outlines the principal issues involved in cases coming before the committee on appeal. He assists the chairman of the committee in selecting hearing subcommittees and in scheduling hearings. To the extent that his other duties allow, he attends those panel hearings which may present novel or difficult problems and advises the panel on matters of procedure and on application of association rules.

He similarly advises the full committee in formulating its recommendations for the disposition of cases appealed or called up, and the board in its deliberations in connection with such cases. He drafts the final board opinions and represents the association in cases appealed to the Commission, including the filing of briefs and the conducting of oral arguments.

Counsel also advises the districts on the application of association rules, and the executive director and the board on questions of association and Commission rule formulation and revision and pending legislative proposals. Rule interpretations or explanations requested by the membership are generally referred to the national office, where the executive director is empowered, after consultation with counsel, to render "office opinions."³⁴⁷ With the growth in membership and the scope and complexity of association standards of conduct, the volume of such work in recent years has become quite significant. Present procedures require the executive director (who, as noted above, spends a large percentage of his time away from the national office) to review and sign all office opinions.

The workload of the office of counsel has steadily increased, particularly business conduct matters.³⁴⁸ One permanent assistant counsel was added in 1962 and another in early 1963.

(b) *Compliance department.*—Before the creation of the compliance department the only national review of district enforcement activities was on an irregular basis, generally upon specific requests from the executive director. The necessity for the creation of the department was pointed up by the failure of certain districts to file complaint actions where examinations disclosed rule violations. For example, in November 1957, the board was forced to supersede the authority of district 5 (New Orleans) and order the filing of complaints in several cases. The following month, the executive committee, on the recommendation of the executive director, authorized the

³⁴⁶ Bylaws, art. V, sec. 4, provides for appointment of counsel by the board.

³⁴⁷ Manual, H-1-2. A literal reading of the applicable board resolutions on this subject would suggest that the staff's authority in this area is quite narrow. Questions involving "interpretations" of the bylaws and rules are required to be submitted to the executive committee. An interpretation is defined as a ruling on a question "where reasonable men, equally well informed, might well differ." In practice, this restriction does not appear to be strictly adhered to.

³⁴⁸ See subsec. b(2)(b), above.

establishment of the compliance department to oversee the enforcement activities of the local districts.³⁴⁹

The compliance department has been in existence some 4 years, but it apparently has been understaffed and has lacked continuity of leadership.³⁵⁰ Its job largely consists of recordkeeping. Although the department is required to review all member examinations, its lack of personnel has reduced this function almost entirely to ascertaining that the examination forms are complete on their face and that the answers to specific items are consistent.³⁵¹

Since the commencement of the Special Study, the association has acted to make the department more effective in its task of review and evaluation of the districts' enforcement activities. In early 1962, it created the post of chief examiner who has assumed the overall supervision of the department.

(c) *Investment companies department.*—The paid staff of the Investment Companies Committee forms this department of the association.³⁵² It consists of the secretary of the committee, two assistant secretaries, and a stenographer.³⁵³

The primary responsibility of the department consists of reviewing investment company sales literature and advertising of members to determine whether they comply with the Commission's statement of policy.³⁵⁴ The committee secretary in recent years has been increasingly called upon by both the committee and the executive director to perform various other administrative duties and at present he devotes only a small percentage of his time to statement of policy matters. The extent to which the secretary is responsible to the executive director or to the committee is not entirely clear.

The routine review of literature and commenting thereon is now carried on primarily by the secretary's two assistants, who devote

³⁴⁹ Among its principal functions, as envisioned by the executive director, were to be: "(1) [R]eview and survey all examiners' reports and report thereon to the executive director for transmittal to the board of governors; (2) review and process complaint dockets—regular, minor violation, and informal; (3) review and process all decisions (including complete survey and constant check on all matters having to do with appeals and reviews of decisions); * * * (6) assume responsibility for preparation of the registration statements [NASD's registration] filed with the SEC and amendments thereto; (7) prepare for presentation to counsel of the association all matters having to do with membership continuance and assume responsibility for disposing of these matters efficiently and promptly; (8) refers to the appropriate district committee any SEC references [of apparent member misconduct] and follow through on these matters; and (9) assume responsibility for publicity in disciplinary matters which require a special notice to the entire membership on any order of suspension or expulsion of a member and notice to the press on any order of expulsion."

³⁵⁰ It generally has had one supervisor and three or four clerks. In its 4 years it has had a total of six supervisors, none of whom has served more than a year and a half.

³⁵¹ See sec. 5.a, below.

³⁵² See subsec. b(2)(e)(i), above, for a description of the Investment Companies Committee.

³⁵³ In early 1963, the committee secretary became the "director" of the department and a new secretary was appointed to serve under the director. In addition, a group of examiners who will specialize in inspection of members engaged in mutual fund sales and distribution is being formed in the national office.

³⁵⁴ See Manual, J-1-3 and ch. XI.B; the Manual, J-1-2, contains the filing requirement with respect to NASD members. Sec. 24(b) of the Investment Company Act requires the filing with the Commission of sales literature disseminated by underwriters and investment companies. Sales literature disseminated by nonmembers of the NASD, is reviewed by the staff of the Commission. The Commission staff from time to time spot checks NASD member literature.

The association announced in April 1959 that it was discontinuing its previous service of clearing literature prepared by nonmembers for sale to members. One reason for the change in policy was that the large volume of such materials was interfering seriously with the department's ability to service NASD members. NASD News, April 1959.

approximately 90 percent of their time to this task. The members of the committee almost never concern themselves with that routine. In 1961 over 10,000 pieces of literature were filed, of which approximately 4,700 required comment. Although the amount of literature filed has increased steadily over the years, the number of pieces requiring comment has remained fairly constant.

Since 1950, when the Statement of Policy and the department came into existence, the tone and overall content of mutual fund sales literature and advertisements have materially improved. It is believed that the department has contributed significantly to this result.³⁵⁵ It is worthy of note that this is virtually the sole area of NASD regulatory activity where the staff has a degree of latitude in formulating and communicating to members official association views in specific cases. Also, since the districts frequently refer Statement of Policy questions to the department before taking disciplinary action, the problem of attaining conformity with national policy has not been serious in the investment companies area.

(d) *Membership department.*—The membership department is responsible for screening all applications for membership of firms and for registration of individuals. Its primary function is to make certain that only qualified firms and individuals are admitted to membership or permitted to register. In addition, the department administers the examination for registered representatives.

The department has 13 employees. Their work is largely ministerial since entry standards are objective and policy considerations are normally not involved in the processing of member and registered representative applications, but if the extensive revisions of standards and procedures for entering the securities business recommended in this report and incorporated in legislation recommended by the Commission are adopted,³⁵⁶ the operations of the department may have to be materially reshaped.

c. *District organization*

(1) *Basis of local autonomy and definition of boundaries*

The bylaws of the NASD provide that there is to be "a maximum degree of local administration of the affairs of the association."³⁵⁷ To accomplish this purpose, the territory served by the association has been geographically divided into districts. A chairman of the board of governors stated in the early days of the association:

For purposes of administration the country is divided into 14 districts. Each is under a district committee elected by members, and one of the fundamental principles in the structure is decentralization; that is, "home rule." By such decentralization local conditions are recognized, whether by provision for establishment of local rules and local business practices, or by local administration of such rules and local handling of trade practice complaints. Rules and customs of local markets must be protected, because by and large local types of security, methods of handling transactions, and details of carrying on business have been evolved to meet local needs. There are, however, certain basic principles which should be recognized and followed everywhere. There must

³⁵⁵ See the recommendations in ch. XI.B concerning the Statement of Policy. The Investment Companies Committee reported to the board in 1959 that "[I]t would appear obvious that the association's sales literature review program has in no way interfered with sales and in fact may have helped promote growth in this sector."

³⁵⁶ See ch. II.F, and the provisions of S. 1642, 88th Cong., 1st sess. (1963).

³⁵⁷ Bylaws, art. IV, sec. 10. At this writing, consideration is being given to changing this language so that the purpose of district committees will be that of "providing local representation in the administration of the affairs of the association."

be national rules and practices. Centralization in the structure has been carried only to the point necessary to bring about coordination, so that 14 teams of horses may not run too much in different directions.³⁵⁸

Over the years district alignments have not always remained in balance. As early as 1947 a special committee reported to the association:

At present NASD is divided into districts which were originally created along what was at the time presumed to be sound business relationship lines. The result is that the association has a few very large and a few small districts geographically; some large districts numerically and some very small districts. The objective of tying together areas and communities having harmonious and logical trade interests does not always seem to have been realized under the existing setup.³⁵⁹

Further exploration of these problems yielded no immediate results, and the original geographic arrangement of 14 districts remained in effect until January 1, 1959, when a plan was put into effect which realigned certain of the districts and reduced the overall number of districts from 14 to 13. The new boundaries appear in table XII-6. The special committee of the board of governors which formulated this plan stated that it was guided by "the logical aspects of territorial division, equities as to representation on the national board, and the problem of improving both local and national administration in the various districts." The committee indicated that it also considered the "flow of trade between the various financial centers." Nevertheless, 1959 realignment did not bring about any major changes.

(2) District committees

The bylaws provide that each district is to be governed by a district committee. That committee, as agent of the association, administers the affairs of the association at the local level.³⁶⁰ It also acts as the district business conduct committee in all the districts. The district committee is the basic organizational unit in the association hierarchy.

(a) *Selection of district committee members.*—The number of district committeemen who represent any district is not fixed by the bylaws, but there may be no more than 12 unless the board of governors specifically authorizes an increase.³⁶¹ Each committeeman serves for a 3-year term without compensation and is selected from the member firms and branch offices located in the district.³⁶²

District committeemen are chosen in much the same manner as are members of the board. Nominees are selected by a nominating committee of five appointed by the district committee (the same committee which selects nominees for the board of governors).³⁶³ Nominating committee candidates automatically become elected if there is no opposition. Ten percent or more of the members having places of business in the district may put up an opposition candidate, in which case an election takes place.³⁶⁴ Since 1955 this procedure has been used

³⁵⁸ Address of Francis A. Bonner before the New York Security Dealers Association, New York, Mar. 26, 1940.

³⁵⁹ NASD Newsletter, July 1947.

³⁶⁰ Bylaws, art. IV, sec. 18.

³⁶¹ Bylaws, art. IV, sec. 10. Such increases have been authorized only in district 12 (New York). See subsec. c(3)(a), below. Not all districts have the maximum number of committee members provided for under the bylaws. As of Dec. 31, 1962, 9 out of the 13 districts operated with fewer than 12 committee members. See also table XII-6.

³⁶² Bylaws, art. IV, sec. 11.

³⁶³ Bylaws, art. IV, sec. 12(a).

³⁶⁴ Bylaws, art. IV, sec. 12(b)-(c).

only twice; in one instance the opposition candidate was not successful and in the other the regular nominee withdrew in favor of the opposition candidate.

Under the original Investment Bankers Code³⁶⁵ the members of regional governing bodies were appointed by the central governing body of the code committee. Some of the founders of the NASD wanted to retain this feature of the code but feared that such appointive powers, in the absence of some semblance of democratic election procedures, would not be acceptable to the Commission as consistent with the spirit of the Maloney Act legislation. Selection by a nominating committee with a right conferred upon members to nominate opposition candidates was the compromise effected. To reduce the possibility that the existing leadership would perpetuate itself in office, the Commission insisted that the bylaws of the association specifically prohibit the nominating committee from renaming an incumbent without first obtaining majority approval of the membership.³⁶⁶ Only rarely have nominating committees sought approval to nominate an incumbent committeeman for a second term.³⁶⁷

The nominating committee is appointed by the chairman of the district committee with the approval of the other members of the committee. An individual appointed to a nominating committee must have a place of business in the district and may not be a member of the district committee.³⁶⁸ The absence of any further limitations upon service on nominating committees has resulted in the same individuals and different individuals from the same firms being repeatedly represented on such committees. In some instances, the same firms have been represented on both the nominating and district committees at the same time.

The larger firms, particularly NYSE member firms, have been predominant on the district committees.³⁶⁹ For example, 74 (or 60 percent) of the 123 district committee members in 1961 were affiliated with NYSE member firms. Eight of the nine district committeemen of district 3 (Denver) and 14 of 18 in district 12 were from NYSE member firms.

Some degree of large firm predominance and perpetuation may be inevitable in view of the tendency of larger firms to take an active role in the affairs of the association and the small number of active over-the-counter firms in some of the districts.³⁷⁰ In any event, the fact that a large firm has a representative on the district committee does not mean that he is not well versed in local over-the-counter problems. The representative is often the partner responsible for over-the-counter activity in the firm and its local over-the-counter business may be of greater importance than its other local securities activities.

³⁶⁵ See sec. 2, above.

³⁶⁶ Bylaws, art. IV, sec. 12(a).

³⁶⁷ This procedure has been used to select an individual appointed to complete the unexpired term of a committeeman who had resigned or died, and thus to give the successor a full 3-year term. See bylaws, art. IV, secs. 12-13.

³⁶⁸ Bylaws, art. IV, sec. 12(a).

³⁶⁹ Of the 35 largest investment banking firms (i.e., those with total capital in excess of \$10 million in 1961) 27 have been represented on one or more district committees in the 10 years 1952-61, and 11 were represented in 1961. Finance, Mar. 15, 1962.

³⁷⁰ This is not the case in all districts. District 11, for example, apparently has experienced no problems in obtaining the services of individuals from small firms. Similarly, the district 8 secretary, who has held that position for 20 years, could not recall having any particular difficulty in obtaining persons to serve on district committees. However, he recalled that some individuals have turned down a proffered board nomination because of insufficient time that could be devoted to that office.

The principal activities of the firms represented on the 1961 district committees appear in table XII-9. Underwriting, over-the-counter retail, and exchange commission houses apparently have had ample district committee representation. Wholesale trading firms have been represented but to a lesser extent.

Firms whose primary activity is mutual fund retailing have one seat on each of five district committees, whereas 30 percent of the active broker-dealers registered with the Commission that responded to questionnaire OTC-3 reported this as their primary activity. Although trading firms as such have had a comparatively small number of district committee seats, many individuals who have prominent roles in their firm trading departments are represented on the various district committees.

The investment company underwriter segment was represented on only one district committee, district 4 (Kansas City), in 1961. The explanation advanced by association staff officials for the lack of functional representation of this group varied. One reason expressed was that this group in general has made no demand for district recognition. Some staff members pointed out that such firms are principally located in the northeastern part of the United States, and thus really do not present problems of fair representation for the majority of the districts. As to those districts where such firms are an important part of the securities community, districts 11 (Philadelphia), 12 (New York), and 13 (Boston), various explanations were also advanced. In district 13, where the investment company industry has long had a significant place, individuals from investment company underwriter members have been excluded from district committee membership because of a feeling that such individuals could not be impartial in their judgments on business conduct matters in view of the investment companies' dependence on the sales efforts of broker-dealer firms, and the opinion of some that individuals from such firms did not have a general knowledge of the securities business.

The former secretary of district 11 observed that, since most of the problems coming before the district committee are unrelated to the investment company aspect of the business, and since there are only a limited number of committee appointments each year,³⁷¹ the committee believed that there was no reason to make any special effort to obtain representatives from this segment of the industry. In his words: "They [the nominating committee] got very good men to serve and they let it go at that."

(b) *Functions of the district committees.*—In practice the district committees, as such, have very limited functions, apart from their operations as business conduct committees. District committees make certain committee appointments, pass on new membership applications,³⁷² with the approval of the board of governors they hire all

³⁷¹ The range of choice is, of course, also limited by the need for geographic and size representation.

³⁷² Under the free-access philosophy of the Maloney Act, membership qualifications are readily determined, and the discretion of the district committees is normally not involved. See ch. II.

At least one district committee, district 10 (Washington, D.C.), has been dissatisfied with the statutory standards to the point that it has repeatedly "disapproved" member applications of firms qualified under those standards where it felt that because of lack of experience or capital the applicant should not be in the business. Such applications ultimately have been approved by the national office.

The district committees are responsible for the initial hearing and recommendation in member continuance proceedings. See pt. I and sec. 3(b)(1)(b), above.

district staff personnel; and they educate members and other dealers in the objectives and purposes of the association.³⁷³ None of these duties has consumed much of the time or efforts of the district committee members.

District membership meetings are infrequently held. Only district 11 (Philadelphia) holds such meetings on a regular basis, and these take place only once a year. Some districts have not held general membership meetings in many years, and some districts that have in the past held such meetings have abandoned the practice.³⁷⁴ Notices, letters, or bulletins from the district committees to the general membership are seldom used. The districts that do communicate with the membership in this manner do so on an irregular basis.

In most districts, new association members are interviewed by district committeemen and/or the district secretary. These interviews are generally used to inform the new member of the rules of the association and are supplemented by the use of "checklists."³⁷⁵ District 8 (Chicago) goes further and offers to assist new members in many problems which confront a firm trying to get started in the securities business, such as proper recordkeeping techniques. These services to new members are provided without cost by the established members. Other districts, such as the important New York district, do very little along these lines.³⁷⁶

Many committees meet only once a year, generally to take up organizational matters, such as election of district committee officers and appointment of standing committees and, on occasion, matters of concern to the investment community.

(c) *Committees of the district committees.*—Under the bylaws each district committee is required to appoint a district business conduct committee, a nominating committee,³⁷⁷ and such standing and other committees as it deems necessary.³⁷⁸ The district committees generally have only one other standing committee, a quotations committee.³⁷⁹

(3) *District business conduct committees*

(a) *Their functions.*—Although it is not required by the bylaws, the full district committee traditionally serves as the district business conduct committee. Such committees are charged with the enforcement of the association's bylaws and rules of fair practice. It has been estimated that the work of these committees accounts for 90 percent of the time devoted to association affairs by the members of the district committees.

³⁷³ Bylaws, art. I, sec. 4; art. IV, sec. 19; art. V, sec. 6. Art. IV, sec. 19 also provides that the district committees "shall consider the practical operation of all provisions of the certificate of incorporation, bylaws, rules of fair practice, and code of procedure * * * and shall report * * * any which do not work satisfactorily in their respective districts." This is sometimes done.

³⁷⁴ In recent months renewed interest has been generated in having local membership meetings. See sec. 6, below.

³⁷⁵ These checklists are now furnished to new members by the membership department. They consist of a list of questions designed to encourage the member to acquaint himself with the basic Commission and association rules applicable to the member's business.

³⁷⁶ In district 12, there is no comprehensive program calling for new-member conferences. Such interviews as have been conducted in recent years in this district have occurred where it has been determined that the new member or applicant presents a potential enforcement problem. These interviews, therefore, have little educational value other than to advise the new member or applicant that there will be close surveillance of his activities. Such interviews are a staff function, and only rarely do members of the district committee participate.

³⁷⁷ See subsec. c(2)(a), above.

³⁷⁸ Bylaws, art. VI, secs. 2-3.

³⁷⁹ See the discussion of the operation of the NASD quotations committees in ch. VII.D.4.a.

Delegated to the business conduct committees are review of all examination reports submitted by NASD examiners; investigation of all complaints made by the public against members of the association;³⁸⁰ filing of complaints against members and registered representatives for violations of the bylaws and rules of fair practice; and adjudication of disciplinary proceedings.³⁸¹

In recent years, as the workload has increased, the district business conduct committees have had difficulty in meeting their enforcement responsibilities. For example, in 1951 the district business conduct committee had 737 examination reports to process; in 1961 there were 1,963, an increase of 166 percent. The increase in the number of formal disciplinary proceedings was even more dramatic. In 1951, only 27 complaints were filed in all districts; in 1961, the number was 422, a 1,500-percent increase. Between 1939 and 1956, a total of 876 complaints were filed, only slightly more than twice the number of complaints filed by all districts in 1961 alone.³⁸²

With the increasing workload, the backlog of undecided cases has mounted. As of January 1, 1958, there were 116 cases awaiting decision. Four years later there were 376, a 224-percent increase.

While some districts have been more resourceful than others in coping with this situation, all districts have had to make adjustments and adopt shortcuts to deal with the cases to be investigated, reviewed, and disposed of. These adjustments, however, do not meet what appear to be the fundamental problems: the limitations on the time and energy which volunteer members can devote to business conduct matters and inadequacies in size and authority of the paid staffs.

The important New York district has had particularly pressing problems. Backlogs of unreviewed examinations and free-riding questionnaires, complaints authorized but not filed, cases not heard, and decisions not rendered have built up at a rapid rate. As of December 31, 1961, the district had 238 unreviewed member examinations between 4 months and 3 years old, of which only 86 had been preliminarily reviewed by the staff. Certain of these 86 raised questions of association rule violations and, although all had been ready for committee review since September 1961, they were not presented for disposition. The district secretary stated:

The reason they were not previously presented is that for lack of available man-hours, orders for complaints issued by the committee prior to September have not yet been carried out. On December 31, 1961, 60 such orders based on free-riding questionnaires and 7 based on examination reports had not yet resulted in complaints. Had the 86 reports been presented to the committee, we would have succeeded only in increasing the number of unfulfilled orders for complaint, thus substituting this backlog for a backlog of reports awaiting committee action. We considered the latter as the lesser of these two evils.

With respect to the 152 examinations over 4 months old which had not yet been reviewed by the staff, the following observation of the district secretary is pertinent:

The volume of business to be handled in this office must be keyed not to the number of inspections that can be made by our 12 examiners or to the number of meetings of the examination committee that can be convened, but to the number of reports that can be processed by the men responsible for reviewing these

³⁸⁰ The handling of public complaints is discussed in sec. 5.d, below.

³⁸¹ See rules of fair practice, art. IV, secs. 2-4; code of procedure, sec. 2.

³⁸² See table XII-f, above.

reports, making recommendations to the examination committee and carrying out the orders of that committee.

According to the district secretary, it was here that the most crucial staff shortage existed.

Even the above statistics do not portray the full dimensions of the backlog. During 1960 and 1961 the district secretary filed away numerous examination without action and without presentment to the district business conduct committee.³⁸³ Some of these examinations were 2 years old at the time and many indicated one or more actionable violations of association rules. Before filing away some of these examinations, the district secretary sent a "letter of caution" to the member pointing out the violations indicated in the report.³⁸⁴ Some of these letters of caution were mailed more than a year after the examination.

At the close of 1961, district 12 also had a backlog of 132 pending formal disciplinary cases; of these, 105 were free-riding cases.³⁸⁵ By contrast, only 26 undecided cases had been pending in the district at the end of 1960.

District 12 has also had difficulty in meeting the minimum membership inspection requirements of the association, calling for the examination of one-third of all members' offices (branch and main) each year.³⁸⁶ Of approximately 680 main office and 270 branch office inspections required to meet the minimum standards, only 435 main offices and 8 branch offices were inspected in 1961. In the first half of 1959, the district had seven examiners assigned for budget purposes but only four men available to conduct examinations, three for special examinations and one for routine examinations; there were also an assistant secretary, one examiner-supervisor and one counsel. In the spring of 1961, shortly before the hearings authorizing the study, there were eight authorized examiners, with four active and four vacancies, and an additional examiner-supervisor and counsel.

Although district 12 has had increased workloads and mounting backlogs since the early 1950's, neither the board of governors nor the district committee has developed a long-range program for dealing with them. When matters exceeded manageable proportions, stopgap measures were adopted. Increasing the number of district business conduct committee members, first from 12 to 14 in 1956, then to 16 in 1957, and finally to 18 in 1958, solved little. While enlargement of the committee may have eased the workload of the individual committee members,³⁸⁷ it increased the burdens of the already undermanned staff.

³⁸³ The district secretary stated he does not maintain records which would show the number of examination reports filed away by him. On the basis of a test review of member examination reports for the years 1959 and 1960 made by the staff of the Special Study, it is estimated that at least 200 examinations fall within this category.

³⁸⁴ See the discussion of the use of letters of caution in subsec. c(3)(b), below.

³⁸⁵ Not including minor violation cases and cases decided by the district and pending before the board.

The number of free-riding cases should be considered in light of the discussion of the phenomenal increase in new issue offerings during the period from 1959 to 1961. See ch. IV.B. Most of the pending cases resulted from a special effort made by the district in mid-1961 to dispose of a backlog of over 1,200 unprocessed free-riding questionnaires covering offerings during the period from August 1958 to January 1961.

³⁸⁶ See sec. 5.a(3), below.

³⁸⁷ A special committee of the board appointed to report on the problems of district 12 stated in May 1961:

"At the committee level, difficulties have been experienced at times in obtaining a quorum for a meeting."

A proposal to reduce the quorum requirements of the bylaws was presented but was referred back to the district committee for further consideration.

Increased demands on the staff also emanated from another source. In connection with all disciplinary cases, other than free riding, the practice for several years has been for the district business conduct committee to assign hearings to panels composed of three industry members each. The chairman is usually a member of the committee, while the other two members generally are selected by the chairman from a roster maintained by the district secretary, which includes the names of principals of prominent firms located in the district. These panels hear the case and make a recommendation to the full committee as to its disposition. The staff provides the panels with a variety of services such as scheduling hearings, preparing cases, and counseling them as to NASD methods and procedures and application of Commission and association substantive standards of conduct. The roster and the number of panels have grown with the volume of disciplinary proceedings. In 1960, 96 volunteers served on hearing panels in addition to the 18 committeemen. In 1962, the chairman of the district committee found it necessary to write to 114 members seeking additional volunteers to serve on panels.

In the middle 1950's the district committee of district 12 transferred to the staff the function of filing, without further action, reports showing no violations or simple "technical" violations and sending out letters of caution calling attention to certain kinds of minor violations. These broad and unprecedented powers were conferred in order to alleviate the backlog of unreviewed examination reports. It failed to do so appreciably, however, partly because the committee did little to secure the additional personnel needed to carry out the added powers. In September 1960, the arrangement was terminated.

In 1959, the executive office undertook a mass examination in district 12, with the help of home office examiners, of upstate New York, New Jersey, and Connecticut firms. The program was apparently instituted as a result of the district's inability to comply with the board's frequency goals,³⁸⁸ particularly in those areas. The reports of these examinations, some 150 in number, were lodged with district 12, where they were reviewed and processed for the most part by only 2 individuals in addition to their routine duties. Little assistance was provided by the executive office. As of December 31, 1961, the district still had not processed the last of these reports. The district secretary stated in his report of December 31, 1961:

By the middle of 1961 it became clear that the net effect of our concentration on the old examination reports was to substitute a more current backlog of reports for those which had been carried over from previous years. By the end of August we had substituted 118 current reports for 112 old reports.

The enforcement mechanism in district 12 has been seriously deficient. In recent months, however, there have been encouraging signs. To some extent because of less active market conditions in 1962, staff members have been able to concentrate on reducing the various backlogs. Progress of a more basic nature has also been made. The new staff leadership which took office in late 1960 has been outspoken in making known the district's need for more staff personnel. It has initiated a procedure for reviewing examination reports which should make a more appropriate division of labor between committee members

³⁸⁸ See sec. 5.a (3), below.

and the staff.³⁸⁹ In mid-1961 the board of governors authorized the employment of eight additional examiners for the district. This enabled the district to promote two of the existing examiners to supervisory positions in 1962.

These improvements are only a beginning in solving the district's problems. The district secretary stated in September 1962 that the then complement of 12 examiners was not adequate to examine annually one-third of the members in the district on a routine basis. Still excluded from the then projected examination coverage were inspections of branch offices and of all new members, which under the policy of the board of governors should be examined within 6 months of admission to membership.

The business conduct problems of district 8 (Chicago), the second largest district, like those of district 12, have been due largely to an inadequate number of staff personnel. In May 1962, the staff of the district secretary consisted of three examiners, an examiner in training, one man "doing quotations work," and three office girls. There were, at the time, approximately 400 association members, 9,800 registered representatives, and 700 branch offices in the district.

One result of the smallness of the staff was revealed in the following testimony of the district secretary:

Q. Are your examinations reviewed by a staff member prior to submission to the district committee?

A. No. No. If I have time and I could go over it, I would go through an examination report prior to that being looked at by a member of the district committee. But in the recent or past several years, they have been submitted to a member of the district committee for study and review.

Q. So you are saying that a member of the district committee actually does the review in the first instance?

A. Well, things are pointed up. He can see what it is that we would like to have some special attention on, and he will make a note of items that he thinks should be covered by way of getting further information or having the report examined by the full committee, or there is nothing of any substance in the examination report causing it to be considered further.

Q. Who points this up?

A. The member of the district committee that studies the examination report. We have, in other years, made a little note to observe this and observe that, but many of them go out cold, so they can look at the examination cold.

Thus, each member of the district business conduct committee is a one-man examination review subcommittee. Each completed examination report is sent to a member of the committee for disposition, in most instances without review or recommendation of the district secretary.³⁹⁰ The function of these one-man committees is explained in a letter of instruction which accompanies examination reports sent to new committee members:

The practice has been followed whereby individual members of the committee are given an opportunity to examine as a subcommittee inspection reports

³⁸⁹ This procedure, as outlined by the district secretary, provides for the following:
 "1. *Review by senior staff member.*—This review results in a staff recommendation to file without action, to write a letter of caution or to file a complaint. If action is to be recommended, the letter or complaint is drafted and all necessary evidence and supporting schedules are prepared for presentation to the examination committee. [In March 1962, examination subcommittees of the business conduct committee were empowered to file complaints.]

"2. *Review by examination committee.*—If the committee acts on the recommendation of the staff only the mechanical preparation of the papers is necessary to carry out the committee's order."

³⁹⁰ In cases where the member encounters a special problem during his review he has at times requested the district secretary to go over the report and advise the member of his views of the matter.

for the purpose of making recommendations for handling or disposition. * * * I would suggest that you formulate your recommendations in terms substantially as follows:

1. Pass and close—no further action required.
2. Refer to full committee for consideration and decision.
3. Send a cautionary letter on specified items.
4. Call in for conference.
5. Any other special recommendation.

If you find it impossible to work on these reports, please return them and I shall arrange for some other member to study them.

Of the 98 examination reports sent to committee members for review in 1961, 15 percent took longer than 90 days to be reviewed and returned to the district office. The district secretary, on occasion, has had to request that a report be returned where the committeeman had held it for an inordinate period of time—in at least one instance, about 6 months. In many instances the pressures of the members' own businesses prevented prompt review. A further difficulty is that, since review by the committeeman is based almost entirely on what is contained in such reports, he has virtually no contacts with the examiner during his consideration of a report. This review procedure also presents problems in maintaining uniformity and continuity, since there are 12 different individuals reviewing examination reports, with different experience and training, and each year 4 experienced committeemen are replaced by individuals without experience. Finally, this system imposes upon elected officials additional time-consuming duties which district secretaries or other senior staff members have performed elsewhere in the association.

In district 10 (Washington, D.C.), the growing workload has been accompanied by long delays in the processing of complaint actions. In the cases decided by its business conduct committee in 1961, the average elapsed time between the filing of a complaint and the decision was 392 days, and between examination and decision 479 days. These represent increases of 211 and 112 percent, respectively, over 1959.³⁹¹

Several district secretaries testified that permanent examiner assistance was necessary, and practically all indicated that such assistance would be desirable. The secretary for district 10 testified that he needed more personnel, preferably at the supervisory level, to provide help in drafting complaints and preparing decisions. He also stated that he has been unsuccessful in his attempts to obtain such assistance from the executive office.³⁹²

The infrequency of district business conduct committee meetings may have contributed to the delay in disposing of complaints in district 10. In 1960 the full committee met three times, and in 1961 four times. A member of the executive office staff, after review of the district 10 situation in April 1961, concluded:

It is demonstrated that waiting for the committee to act at a regular meeting aggravates the time elapsed on the part of both the committee and the secretary. During 1960, the committee held three regular meetings. However, of the 20 complaint actions authorized at regular committee meetings, only 2 were taken at the April 1960 meeting. In effect, therefore, the committee met only twice in 1960.

³⁹¹ In district 13 (Boston) the average elapsed time in 1961 between complaint and decision and between examination and decision almost approached those of district 10, and in the same 3-year period the rates of increase in elapsed times were nearly as great.

³⁹² See also sec. 4.b, below.

It would appear that more frequent committee meetings would be the more vital action required to materially reduce the 355 days required to process complaints involving Washington, D.C., members.³⁹³

Even district 1 (Seattle), the smallest district, has had its processing problems. One such problem was pointed up in a letter from the district secretary to the executive director in June 1959:

I have reached the point of a "bulge" in the work here that will take some "working off" to get current again. The bottleneck, as I see it, is getting examination reports disposed of by the committee which is moving very deliberately.

Yesterday at a meeting, the committee approved appointment of permanent business conduct subcommittees, and that action will help in disposing of the examination reports which have been ready for consideration for some time.

District 6 (Dallas) apparently has no substantial delays, perhaps because it files comparatively few complaints. In 1961, that district (a one-man office), filed seven complaints and rendered decisions in only two cases, both of which were decided in December 1961. In 1960 eight complaints were filed and nine cases decided, and in 1959 eight complaints were filed and seven cases decided, only two of which involved matters disclosed in member examinations. Four cases in that year, involving violations of the association interpretation on free-riding and withholding, were based upon questionnaires sent out by the executive office rather than local surveillance activities.

The statistics for 1960 and 1961 are all the more striking because in 1960 all 186 main offices and 158 of the 181 branch offices in district 6 were examined under the association's mass examination program.³⁹⁴ Furthermore, a study made by the executive office disclosed that 13 out of 47 examinations during the first 3½ months of 1960 indicated rule violations. Only seven of the decided cases in 1960 and 1961 resulted from examinations in the 2-year period. The association has made certain administrative changes in district 6 involving, among other things, the appointment of a new district secretary in January 1961 and the assignment of a permanent examiner in November 1962.

(b) *Use of informal and summary disciplinary techniques.*—All districts have used abbreviated procedures of one kind or another to keep formal disciplinary proceedings to a minimum and thus lessen the burdens on volunteer committeemen and understaffed district offices. Letters of caution, advising association members of certain irregularities in the way such members have been conducting their business, are perhaps the most widely used "shortcut" technique.

The board of governors has expressed concern over excessive use by the districts of letters of caution. In 1955, their use in district 9 (Cleveland) prompted the board to instruct the executive director to advise the chairman of the district committee that the board was "disturbed with the policy followed." In 1957, the board directed that complaints be filed by the executive director against certain then district 5 (Kansas City) members where the district had failed to act or had sent letters of caution.³⁹⁵

³⁹³ The district secretary disagreed with this conclusion. He maintained that the problem resulted from inadequate staff.

³⁹⁴ See sec. 5.a(1), below, for a discussion of the mass examination program.

³⁹⁵ The 1961 letter quoted in subsec. b(2)(b), above, to a district chairman grew directly out of letters of caution sent to members where free-riding violations had been indicated on questionnaires.

As part of an attempt to cut down the number of letters of caution and partly to help the districts meet their workloads, the board in 1958 instituted a summary disciplinary procedure, commonly referred to as the "minor violation procedure." The districts were given authority where the violations were not part of a course of conduct and were minor in nature to permit the respondent to admit to formal charges, pledge future compliance, and accept a penalty which could not exceed a fine of \$100.³⁹⁶

Some districts did not use the minor-violation procedure at all in the first years after its adoption. Where it was used, instead of reducing the number of letters of caution, the procedure became a substitute for the filing of formal complaints. In April 1960, the Director of the Commission's Division of Trading and Exchanges wrote to the executive director:

I am concerned that complaints resting on allegations [of Regulation T violations or of charging customers unfair prices] were handled by minor violation procedure. In my opinion, complaints resting on such allegations are, by the nature of the charges, serious matters requiring formal complaint treatment. They are in the category with other charges, such as inadequate capital or misuse of firm or customer's cash or securities, even though the penalties may vary in each of those categories. Furthermore, it was my impression that association representatives had expressed similar views in discussions preliminary to the adoption of rules permitting minor violation procedure.

This letter apparently brought about a sharp curtailment in the use of the minor-violation procedure. However, this resulted in even greater reliance upon the letter of caution. It should be noted that the Commission does not receive or review letters of caution issued by the NASD.

The board has done little in recent years to restrict the use of letters of caution. Nor has it established guidelines governing their use. Although such letters are required to be filed promptly with the executive office, they often are filed many months after having been sent, so that it is impossible for the board to take prompt corrective action where required. Since neither the board nor the executive office has indicated what information is to be set forth in a letter of caution, many do not disclose sufficient information to determine whether disposition through the use of a letter of caution was justifiable. This point is illustrated by the following letter sent to a member by district 8 (Chicago) in January 1961:

The committee has considered the allotment of 5,000 shares of this offering that you made to the account of * * * in the light of the "Interpretation With Respect to Free-Riding and Withholding" of the board of governors.

While there apparently were some unusual circumstances involved, the committee believes that the allotment may have been somewhat excessive on the basis of the normal investment practice of the account with you.

The committee is certain that you desire to conform to the letter and spirit of the interpretation. A renewal of your efforts is recommended so that no questions will arise in the future in connection with your distributions.

In 1956, the report of a special committee of the association had this to say about letters of caution:

Regarding policy concerning letters of caution where no formal complaint is involved, the consensus was:

(a) There should be a limit to the number of letters of caution to which a member is entitled. Perhaps one warning on any irregularities should be

³⁹⁶ Code of procedure, sec. 12. See NASD News, July 1957, for a discussion of the background of the minor violation procedure.

sufficient and, if poor management or general disregard of rules is indicated, the entire file of the subject member be placed in the hands of the district business conduct committee for its consideration.

(b) Any letters of caution should be sent by registered or certified mail.

(c) The committee felt that, at present, the board should continue its policy to alert district business conduct committees on any series of violations which seemed to call for more formal action than a letter of caution.

The recommendations of the special committee were not formally adopted by the board nor have they been followed to any great extent by the various districts. An examination of the association's records revealed numerous instances of letters being sent where formal complaint proceedings appear to have been warranted, and some instances where flagrant violations of Commission and NASD rules appear to have been involved.

In 1960 and 1961, district 3 (Denver) sent a letter of caution to one member whose examination report revealed a net capital deficiency, an incomplete ledger, no current monthly trial balance, errors in confirming transactions to customers, and sales memorandums without a required notation as to time of transaction and without written approval by a principal of the member. In seven other instances letters were sent where the examination disclosed numerous markups in excess of 5 percent. In one of these cases, 34 of 50 transactions analyzed and in another 27 of 49 showed markups of over 5 percent. Multiple bookkeeping and Regulation T violations indicated in examination reports were also handled by a letter of caution. At least four times in 1960 letters were sent to members with a prior history of association rule violations, in some instances for the same offense. In early 1961 a letter of caution was sent to one firm on the basis of an examination which revealed high markups, sales memorandums without a required time notation and noncompliance with Regulation T in connection with 26 transactions. Two prior examinations of this firm had turned up similar violations.³⁹⁷

In district 2 (Los Angeles), 24 letters of caution were sent in August 1961 covering such matters as violations of the Commission's and the association's recordkeeping rules, lack of appropriate supervision, excessive spreads, improper confirmation disclosures, and violations of the association's free-riding interpretation. Three of the letters covered more than one violation. In 1961, 28 letters of caution were sent to members in district 8 (Chicago), some indicating as many as 3 rule violations. In a letter of caution sent in September 1961, the district 12 (New York) secretary pointed out that an examination of 1 firm completed some 9 months before revealed at least 18 violations of Regulation T; and in a letter sent in June 1962 covering an examination completed in August 1961, the secretary noted that the examination revealed 4 separate violations of the Commission's bookkeeping rules.

Other districts have also made substantial use of the letter of caution. During the first 6 months of 1961, district 7 (Atlanta) used letters of caution 27 times and district 11 (Philadelphia) used them 34 times. While district 7 restricted its use of such letters primarily to cover bookkeeping irregularities, district 11 has used letters of caution in

³⁹⁷ In 1961 this case, as well as the others described above, received the attention of the chairman of the board of governors, who discussed with the district 3 committee the adequacy of the action taken.

connection with excessive spreads, violations of Regulation T and violations of the association's interpretation on free-riding, among other types of infractions.

Not every rule infraction, of course, is an appropriate subject for a plenary complaint action. Nevertheless, it seems clear that there has been too much reliance on letters of caution as a substitute for sterner discipline. The solution seems to lie in an effective, properly controlled minor complaint procedure,³⁹⁸ greater central control over disciplinary actions, and, more fundamentally, in a direct approach to the problems of inadequate staff and unrealistic divisions of labor between the staff and members of the district business conduct committees.³⁹⁹

4. ASSOCIATION FISCAL POLICY AND PLANNING

a. Budget size and scope

In March 1939 a joint letter was sent to members of the industry by the Commission and the predecessor organization to the NASD seeking comments on a proposal to form a national securities association under the Maloney Act. In that letter the views of the Commission's staff on the amount of funds required to run the proposed organization were set forth:

In order for the new association to do a job of cooperative regulation reasonably well and in a manner satisfactory both to the trade and to the Securities and Exchange Commission, it seems to the staff of the Commission that an annual sum of between \$300,000 and \$450,000 would be required.

Three months later, in its opinion on the registration of the NASD (which included the proposed dues schedule), the Commission commented:

The Commission's [March 1939] communication to the trade expressed the opinion that the relatively small amount which could be collected under the schedule of dues as presently adopted would not be sufficient to enable the association to perform the task of cooperative regulation, which naturally includes adequate self-policing, except to a limited extent. Accordingly, there may well be need for a larger measure of surveillance by the Commission of the members of the association * * *.⁴⁰⁰

The association in its first year spent a little more than \$200,000 or about 67 percent of the minimum which the staff of the Commission had deemed was reasonably necessary to operate in the public as well as the members' interest.

Over the years there has been a steady increase in the association's expenditures, which have grown from \$504,096 in 1950, to \$1,813,300 in 1961, and to \$2,197,033 in 1962.⁴⁰¹ It is difficult to determine with any precision the amounts expended for particular phases of the asso-

³⁹⁸ In the summer of 1961, a conference between NASD and Commission staff members resulted in an understanding concerning the use of the minor violation procedure, in which the association agreed that it would be used for isolated instances of such infractions as Regulation T where the member handles a substantial volume of business; failure to register salesmen because of oversight; unintentional and immaterial bookkeeping or confirmation inadequacies; free-riding where few shares are involved; high markups which appear to be only a lapse from correct procedure.

³⁹⁹ In requesting the board to consider adoption of an arbitration code in 1958, Mr. Fulton commented:

"I believe that the board will agree that the time is coming when it must do all it can to free district committees from unnecessary business conduct work so that they may devote sufficient time to necessary enforcement problems and still have some time left to tend to their own business."

⁴⁰⁰ *In the Matter of National Association of Securities Dealers, Inc.*, 5 S.E.C. 627, 631 (1939).

⁴⁰¹ Budgeted expenditures for fiscal 1963 are \$2,613,390. For a discussion of recent association developments, see sec. 6, below.

ciation's activities. For example, many of the paid officials devote time to several phases, and the time spent by an individual on a particular activity may vary considerably from period to period. There is little question, however, that by far the largest part of association expenditure relates to self-regulatory activities; i.e., regulatory policy-making and enforcement and the administration of the registration and qualification-examination program for registered representatives. In 1961 association officials estimated that about 60 percent of annual expenses were "incurred in connection with investigations and complaints."⁴⁰² Public relations activities in fiscal 1961 cost about \$22,000, and the retail quotations systems about \$60,000; these appear to be the two largest nonregulatory items.

Despite the emphasis on regulation and the steady increase in expenditures over the years, expenditures in relation to the size of the association have remained conservative.⁴⁰³ This is made clear by a comparison of table XII-10, summarizing the growth in association expenditures since 1955, with table I-18 in chapter I, showing the growth of the organization expressed in terms of members, registered representatives, and branch offices.

b. Budget preparation and responsibility

Under the association's bylaws,⁴⁰⁴ the board of governors is required each year to estimate the coming year's expenses and formulate an equitable dues and assessment schedule to meet these expenses. The informal procedure developed by the board to carry out these responsibilities calls for the comptroller to draw up a preliminary budget under the supervision of the executive director and the board's finance and executive committees. The department heads and the district committees are required to submit expense requests to the comptroller for inclusion in the preliminary draft of the budget.

The comptroller presents to the finance and executive committees the data collected by him, but he plays no part in deciding how large the budget will be or in selecting methods for obtaining the necessary funds. These decisions are made by the finance and executive committees.⁴⁰⁵ The dues schedule is considered to be an NASD rule and is filed with the Commission, which is vested with the power to disapprove the schedule if inconsistent with the statutory standards.⁴⁰⁶ Although not required by statute or Commission rule, such filing is normally accompanied by supporting budgetary data including an estimate of receipts and expenditures.

The executive director plays an important role in budgetary matters. The board generally has relied upon his judgment and has required that requests for additional funds on either the national or local levels have his approval. As a consequence, requests for additional funds are usually cleared informally with the executive director before inclusion in a district's proposed budget.

⁴⁰² Hearings on H.J. Res. 438, "Securities Markets Investigation," before the Subcommittee on Commerce and Finance of the House Interstate and Foreign Commerce Committee, 87th Cong., 1st sess., pp. 78-79 (1961).

⁴⁰³ Budgeted revenues and expenses for 1963 and 1964 show considerable increases. See note 401, above.

⁴⁰⁴ Art. III, sec. 1.

⁴⁰⁵ See subsec. b(2)(a), above.

⁴⁰⁶ Sec. 15A(b)(6) of the Exchange Act requires that "the rules of the association provide for the equitable allocation of dues among its members to defray reasonable expenses of administration," and sec. 15A(j) provides for Commission review of additions and changes to NASD rules. See pt. I, below.

The budget requests submitted by the district committees generally do not reflect any material consideration having been given to the possibility of an expanded role either in purely regulatory activities or in providing service to the members. In April 1957, the executive director wrote to the chairmen of the district committees requesting that they prepare "careful and exact" estimates of their requirements and citing the following portion of the report of the chairman of the finance committee to the January 1957 meeting of the board:

In recent years it has been noted that some districts submit the exact amounts approved for prior years, or submit figures double the 6 months' expenses as shown on statements provided them. It is only fair to state that in other districts the budgets reflect careful thought of the committees prior to the preparation of the requests.

If figures are pulled out of the air, it is necessary, in many cases, for the district committee, sometime after the start of the fiscal year, to request additional funds for projects which they had in the development stage prior to the preparation of the budget.

Inasmuch as dues, fees and other charges to be levied are based on budgets, the budgets should be prepared carefully and thoughtfully and should, insofar as possible, anticipate all expenses for the next year. Under the bylaws, the association cannot levy against the membership any fee which is not fixed 30 days prior to the start of the fiscal year. The district committees should be concerned at the time of budget preparation with a review of past activities and with a realistic appraisal of the future.

Nevertheless, there is little evidence of any subsequent change in the district committee approach to budgetary problems.

To a large extent, the shortcomings in association performance noted in this report can be traced directly to material inadequacies in the number of staff personnel at both the national and district levels—a fact about which officials have shown some awareness and concern. Yet in some instances where districts have included requests for additional personnel, such requests have been denied at the national level. For example, in 1958 a district 12 (New York) request for additional examiners was disallowed, apparently without explanation. A request submitted by district 10 (Washington, D.C.) in 1961 for supervisory assistance was denied although the committee addressed the following resolution to the board:

Resolved, That the chairman of the district committee for district No. 10 of the National Association of Securities Dealers, Inc., be instructed to formally advise the board of governors of the association as follows:

That, in the opinion of this committee the activities of marginal and highly promotional security dealers who are members of this association and rapidly growing in number in the District of Columbia, require the immediate action of the association in the public interest and in the interest of the association and that, in the opinion of this committee, the staff of the district secretary is inadequate to meet the requirements of the special situation which exists within district No. 10.

The national organization has often approved items submitted in local budgets which on their face indicated insufficiencies in the ability of the districts to carry out their responsibilities. Moreover, after the budget has been formulated, there has been an absence of procedures for assuring that programs provided for in the budget have been carried out.

c. Financial capacity and resources of the association

The association's annual revenues usually have exceeded its annual expenditures. At the end of fiscal 1961 the association had an ac-