cumulated surplus of over $1,200,000, of which over $700,000 had been accumulated since 1955.[407]

Although surpluses have been accumulating, the financial burdens upon the membership have not increased appreciably. Under the 1961 assessment schedule, about 70 percent of the membership was assessed under $100, the lowest assessment category. Between 1956 and 1960 the percentage of all members falling in this category ranged from 63 percent in 1959 to 78 percent in 1957. At the other extreme, less than 1 percent of the membership paid the maximum assessment, which was $6,000 between 1955 and 1959 and $8,000 between 1959 and 1961.[408]

The association derives its income from two general sources: (1) direct assessments against the membership and (2) service items and miscellaneous revenues. Included in the latter category are such items as registered representative application and examination fees, branch office fees, membership admission fees, fines and costs imposed in disciplinary proceedings, and interest from invested surplus funds. Originally, income from service items was intended to cover only the cost of administration involved in generating such income, but in recent years it has been more than sufficient for this purpose. In 1960 and 1961, such income constituted over 40 percent of the total revenues collected by the association.

The principal source of revenue from service items are the registered representative application and examination fees. Between 1955 and 1961 the association collected $10 from each applicant for registration as a registered representative and an additional $10 where the applicant took the association's qualification examination.[409] In 1961 such fees accounted for $704,180, or 37 percent of the association's total revenues for the year. In fact, enough has been produced from these sources for the association to be able to reduce its annual general assessments by almost $50,000 between 1959 and 1961 and still show an overall increase in annual revenue of $170,000 for the 3-year period.[410] Notwithstanding a rise in expenses of nearly $1,600,000 between 1939 and 1961, the receipt of nonassessment revenues has enabled the association to limit the increase in the annual general assessment over the same period to $630,000.

While the relative importance of assessments in the total budget has diminished over the years, nevertheless in view of their recurring nature and predictability, they must still be considered the association's most important source of revenue. Since 1943 there have been basically four elements making up members' assessments: (1) a fixed annual membership fee; (2) a "head tax" on personnel; (3) a fee levied on conventional underwritings; and (4) a fee on underwritings of investment company shares. The particular rate of assessment for each of these items has not remained constant. The basic membership fee, for instance, has increased from $30 in 1943 to $65 in 1961.[411] The head tax on personnel has undergone several changes in definition as well as in rate. The 1961 rate was $3.50 per individual, [412] a decrease of $4 from the 1959 high of $7.50; for the years 1943–59, part-time

[407] For fiscal 1962, excess of income over expenses was $115,103.
[408] The increase in the maximum assessment to $8,000 resulted in a small decrease in the number of firms coming within this category.
[409] See sec. 6, below.
[410] See table XII–10.
[411] See sec. 6, below.
[412] Ibid.

salesmen were assessed at only one-half the regular rate, whereas since 1960 personnel devoting any time whatever to the business have been assessable at the full rate.

The two underwriting components have similarly been changed several times. From 1944 to 1958 the first $100,000 of underwritings (both conventional and investment company) was not subject to assessment, but since 1958 this exclusion has been dropped. Conventional underwritings, originally assessed in 1943 at 0.01 percent and reaching a peak in 1946 of 0.0175 percent, were as of the end of 1961 assessed at 0.0025 percent, an alltime low. Since 1954, underwritings of investment company shares have been assessed at twice the rate applicable to conventional underwritings, the added charge being intended to defray the cost of administering the Commission's Statement of Policy with respect to the sale of investment company shares.[413]

The rates assigned to the four specific elements are weighted so that each one will produce a certain percentage of the entire assessment. Prior to 1959, major weight was given to the underwriting components. In 1956, 47 percent ($364,612) of member assessments was derived from conventional underwriting alone.[414] In 1959, a special committee concluded that 40 percent of the total assessment should be produced from personnel fees, 30 percent from annual membership dues, and the remaining 30 percent from underwriting fees.[415] The special committee recommended that the additional weight be assigned personnel fees on the theory that much of the association's workload was concerned with conduct of personnel. This formula was accepted by the board and has been in effect since 1959.

In 1961, fees based upon conventional underwritings fell to $198,469 (21 percent of member assessments),[416] some $165,000 less than the 1956 figure, at the very time that the regulatory demands on the association were at their greatest and that some of the major regulatory problems before it involved the underwriting process.[417]

The association has always applied a ceiling on its assessments, which has been raised slightly in recent years. From 1950 to 1959 it was $6,000; for the years 1960 and 1961 the overall maximum assessment was $8,000 and individual limits of $6,000 each were placed on the personnel and underwriting components.[418] Because of the ceiling some firms have had little increase in their financial obligation to the association despite tremendous growth in their business. Thus, for the years 1950–59 Merrill Lynch, Pierce, Fenner & Smith paid the same annual assessment of $6,000, while its assets increased by $456 million, its capital by $45 million, and its income from operations by $111 million. But for the ceiling, the firm's assessment for 1959 would have been more than triple the ceiling.

On the other hand, certain members with a much more modest growth found their assessments sharply increased. The 1950 and 1959 assessment figures for four of these firms are shown below:

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[413] Ibid.

[414] This was the high point of underwriting fees in terms of both percentage of assessments and dollar amount for the period 1955–61. See table XII–10.

[415] In the previous year, 35 percent had been derived from personnel fees, 23 percent from membership dues, and 42 percent from underwriting.

[416] Fees from investment company underwritings were approximately 11 and 9 percent of total assessments in 1956 and 1961, respectively.

[417] For example, in the 1959–61 period over 30 percent of the disciplinary cases decided involved alleged violations of the association's free-riding interpretation. See sec. 5(b)(2), below, and table XII–11.

[418] See sec. 6, below.

	Assessments		Percentage increase
	1950	1959	
Firm A	$244.74	$4,249.92	1,637
Firm B	395 60	6,000 00	1,417
Firm C	332.05	4,637.71	1,297
Firm D	454.99	4,738.32	941

The ceiling also, of course, limits the association's revenue. During the 7 years 1955–61, the association "lost" over $750,000 because of the ceiling; in 1959 alone it "lost" $159,000.

Under the association's pattern of assessments, the volume of a member's marketmaking, trading, and retail activities in the over-the-counter markets is not directly taken into account. Some wholesale firms appear to be the primary beneficiaries of this system, since they operate with relatively few employees and engage in relatively little underwriting, but their volume of trading may be substantial.

The returns of questionnaire OTC–3 show 67 firms each with over-the-counter sales of $100 million or more in 1961. These 67 firms accounted for 54 percent of all over-the-counter sales in 1961 ($18 billion out of an estimated $34 billion), but paid only 16 percent of the total assessments. Moreover, the assessments of 27 of these firms were under $1,000, and 12 paid less than $300. The 27 firms assessed under $1,000 accounted for 16 percent of estimated over-the-counter sales, but paid assessments of $12,722—a little more than 1 percent of the total.

For 6 months in 1946–47, the association's assessment formula included a gross-receipts base. Since that time such a basis for assessments has not received further association consideration.

In the final analysis, the budget and the dues structure are inextricably bound together. But, although the association has reviewed its assessment policies several times since 1946 (most recently in 1958), it has confined itself to striking a more appropriate balance among the components (the annual member, personnel, and underwriting fees) from which revenue has traditionally been derived.[419] The potentially expanded association role that would result from the recommendations of this report may require a somewhat broader perspective as to total budgetary needs and as to the appropriate components of the dues structure.

5. REGULATION BY THE NASD OF THE CONDUCT OF ITS MEMBERS

At the hearings on the legislation authorizing this study, the then board chairman of the NASD testified that—

> its [the association's] main function is that of self-regulation of the membership by constant enforcement of its rules and certain of the rules and regulations of both the Securities and Exchange Commission and the Federal Reserve Board.[420]

[419] The report of the special committee appointed in 1958 stated:
"In our deliberations it was necessary for us to take into consideration the operating budget, not as to its size or adequacy, but rather the various sources from which the income to balance the budget was derived. To this extent only, was any consideration given to the operating budget."

[420] 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., p. 63 (1961).
NASD enforcement of Federal laws and regulations is based on the general provisions of art. III, sec. 1, of its rules of fair practice that a member "shall observe high standards of commercial honor and just and equitable principles of trade."

Previous sections have described the organization of the association and the manner in which it functions. In this section the principal regulatory functions of the association will be described and assessed, with particular attention to the methods employed by the association for enforcement of its own rules and those of other regulatory bodies. Consideration will also be given to what might be called the association's "legislative" activities—that is, awareness and analysis of important or new problems and the formulation of policies and programs directed to their resolution.

Although the present section is intended as a summation of these matters, it should be emphasized that previous chapters of the report contain more comprehensive discussions of the NASD's self-regulatory role in connection with substantive topics—for example, Chapter II: Qualifications of Broker-Dealers and Salesmen; Chapter III: Selling Practices; Chapter IV: Underwriting Practices: Chapter VII: Over-the-Counter Markets; and Chapter XI: Mutual Funds.

At the outset it should be noted that, while the legislative history of the Maloney Act makes clear that its basic objective was to provide for industry associations to regulate the over-the-counter markets, the statute placed few limits on their jurisdiction to promulgate and enforce standards of conduct for their members. The only exemption specifically provided was "with respect to any transaction by a broker or dealer in any exempted security," [421] that is, primarily Government and municipal bonds. The association itself added in its bylaws, an explicit exemption for transactions in listed securities,[422] but as a practical matter even that exemption has been substantially narrowed. In 1961, the board of governors, in remanding a district committee's dismissal of a case for want of jurisdiction, stated:

> [T]he board believes it the obligation of the association to take jurisdiction unless clearly prevented from doing so by applicable law or rules. In the case at hand, it would appear that the respondent individual engaged in a course of business which was unethical and resulted in injury and economic harm to a member of the public. Such a course of business, whether it involves conduct denominated as "churning" or any other conduct which operates to the detriment of the public or the investment banking and securities business, should be the subject of prompt and effective disciplinary action. We believe we should be remiss in carrying out the objects and purposes of the association should jurisdiction not be taken in this matter.
>
> We find that the association does have jurisdiction in this case regardless of whether the securities "churned" involved transactions which took place on an organized exchange. We find that whether or not the transactions were traded over-the-counter or consummated on an organized exchange does not alter the fact that the member or a registered representative in the course of its business has an obligation to live up to high standards of commercial honor and just and equitable principles of trade.

The NASD thus exercises controls in realms of underwriting, over-the-counter retail and wholesale business, and mutual fund distributions, and to some extent in respect of business in listed securities.

a. The examination (member inspection) program

(1) *Its organization*

In 1941, the association instituted procedures for systematic inspection of its members.[423] Member inspections in the early years were

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[421] Exchange Act, sec. 15A(m).
[422] Art. I, sec. 3(c).
[423] A board resolution authorizes the board, district business conduct committees, and any duly authorized agent of the association to inspect the books, records, and accounts of any member for the purpose of determining whether it is complying with the association's rules of fair practice. Manual, H-2.

carried out mainly by use of questionnaires. This method proved inadequate and was abandoned in 1947 to be replaced by actual office examinations, on a "surprise" basis, of the books and records of members by staff examiners.

The association conducts three kinds of examination: the routine examination, the special examination, and the "mass" examination. Routine examinations, comprising the vast majority of member examinations, are carried out by district staffs with occasional assistance from the executive office. The routine examination program involves the periodic inspection of all firms located in the district and a general examination of each member's books, records, and business procedures. Special examinations, normally carried out by district staffs, are used where apparent violations of the NASD rules are involved. Their scope is limited to obtaining specific information about the apparent violation from the member or its books and records. The number of special examinations conducted during any period depends, of course, on the availability of the staff and the number of matters requiring special attention. Occasionally, the association conducts a mass examination of member offices in a particular district or part of a district for the purpose of supplementing the examinations by the district examining force. National office examiners and, where necessary, the staffs of other districts assist the local examiners. Approximately nine mass examinations have taken place since 1946.

A close look at the examination program shows that it has many shortcomings, most of which are attributable to the recurring problem of inadequate staff. In 1947, when the association began its examination program, there were six examiners. Eight years later, despite sharp increases in the number of members (from 2,545 in 1947 to 3,481 in 1955), branch offices (from 1,007 in 1947 to 1,704 in 1955) and registered representatives (from 25,900 in 1947 to 44,488 in 1955), the examining force had increased by only 3. By December 31, 1961, when the number of members had grown to 4,750, the number of branch offices to 4,519, and the number of registered representatives to 102,305, the number of examiners had increased to 28.[424]

Some examiners (19 in 4 districts[425] in 1961) are assigned to particular district offices, while the remainder work out of the executive office. In the nine districts to which no examiners were assigned in 1961, the district secretaries carried a substantial part of the examination burden. For example, in 1961 the secretaries of these districts performed approximately 40 percent of the examinations in their districts. In three of these districts the district secretaries performed over 90 percent.[426] Two district secretaries have stated that their primary function was that of examiner.

Lack of examiners has resulted in a sharp curtailment of other enforcement activities in some districts. The district secretaries have little time to look into particular trouble spots, handle applications for extensions of time under Regulation T,[427] perform neces-

[424] The association reported adding 11 more examiners in 1962. At the end of 1962, there were 4,771 members, 4,713 branch offices, and 94,440 registered representatives. See sec. 6, below.

[425] Districts 2, 8, 11, and 12.

[426] Districts 1, 3, and 9.

[427] See subsec. a(4)(1), below.

sary day-to-day surveillance of members' activities, or investigate customer complaints. Moreover, when a district secretary is away from his office making examinations, he is unable to attend to inquiries from members.

During periods when district secretaries in the one-man districts are processing completed examination reports and presenting matters to their district business conduct committees, they generally have little time to conduct member examinations; and in the absence of assistance from the executive office, the examination program virtually comes to a standstill. Thus, in 1961, in four districts five or fewer examinations were conducted during 6 or more months of the year, and in two districts no member examinations were performed in each of three months.

While the temporary assignment of examiners (largely from the national executive office) often provides much-needed assistance to the district secretary, it has presented other problems. According to the chief examiner, "there is a factor of getting to know the district and its peculiarities * * *. You can't get this from a temporary visit." The shifting of examiners from one office to another, in some instances before their work has been reviewed by the district secretary, has hindered the district secretary and business conduct committee in their processing functions and has resulted in examinations being filed away where apparent irregularities were indicated. Reassignment also may prevent examiners from participating in disciplinary proceedings arising out of their examinations; their absence may hamper the development of a full factual record.[428]

A principal justification for the executive office examiners is the desirability of having a "reserve" force to provide some flexibility for dealing with special situations in specific geographic areas, as for example those which existed in district 3 (Denver) during the "uranium boom" and in district 12 (New York) during the "boiler room" activities in that district in the late 1950's and early 1960's. Less emphasis has been given to the desirability of strengthening the surveillance machinery of the districts, where the initial and most vital phase of the policing function lies. In recent months, however, the association has taken steps to make permanent assignments of executive office examiners to certain of the districts now operating without an examining force. In October 1962, permanent examiners were assigned to several districts and it seems likely that in the near future the remaining districts will also receive permanent examiner assistance. A reserve force might then supplement rather than take the place of local staffs.

(2) *Qualifications and training of examiners*

Partly as a result of expansion of the examining force in recent years, most examiners are relatively inexperienced. As of December 31, 1961, 10 of the 19 district examiners and 4 of 9 executive office examiners had been with the association for less than 6 months. The

[428] These problems have been more serious where a mass examination has been conducted. See sec. 3.c(3)(a), above. The secretary of district 3 testified that the reports of the 1955 mass examination in that district took "fully a year to process." In May 1958 the executive director had this to say in reporting on another mass examination:

"In district No. 2, California, the committee finally called a halt. They had given so much time to considering examination reports and filing complaints that they weren't able to keep up with their own business. So we withdrew the four executive office examiners who had been working there and reassigned them elsewhere."

district 12 secretary reported to the chairman of his committee in early 1962:

> But it should not be assumed that we will have a sophisticated staff making sophisticated inspections. The statistics will be produced but the training will be a continuing thing; and the problem of coping adequately with the almost daily frauds and manipulations evident in the "street" today will not be solved in the near future.

In recent years, the association has made a special effort to obtain highly qualified individuals to serve as examiners. Once hired, the new examiner is given 8 hours a day of classroom instruction, covering a broad range of subjects for approximately 4 weeks.

(3) *Frequency objectives of the program*

(a) *Main office examinations.*—Since the early 1950's the association's announced policy has been that one-third of the main offices of its members should be examined each year. The association's main office examination figures for the years 1955–61 appear in the table below:

TABLE XII–g.—*Main office examinations by the NASD, 1955–61*

Year	Number of members at yearend	Number of main office examinations	Percentage of main office examinations
1961	4,750	1,493	31.4
1960	4,466	1,497	33.6
1959	4,142	1,325	32.0
1958	3,896	1,521	39.0
1957	3,867	1,245	32.1
1956	3,634	1,026	28.2
1955	3,350	996	29.7

In considering these statistics several factors should be taken into account. In the first place, both special and routine examinations are included. As previously noted, the special examination is generally limited in scope and rarely includes a broad review of the books and records of a firm. The number of special examinations conducted during any given period may be substantial: for example, of the 1,493 examinations conducted in 1961, about 13 percent were special examinations.

Secondly, the coverage shown by the above table includes multiple examinations of the same member and examinations of members who have been admitted during the year.[429] Thus, a percentage figure of 33⅓ would not mean necessarily that all members were being examined once every 3 years. This is demonstrated by an association study showing that the last routine examination of 759 broker-dealers who were members on January 1, 1962, occurred in 1958 or earlier.

Finally, the cited statistics are based upon overall association averages and do not reflect that certain districts have fallen far short of their goal. For example, no member in former district 4 was examined between January 1, 1954, and December 31, 1957, and no member in former district 7 was examined in 1953, 1955, or 1957. District 12, the largest district, has never met the 3-year objective and in no year since 1958 has examined more than 25 percent of its membership. In 1960

[429] For a discussion of the applicable NASD policy for examinations of newly admitted members, see subsec. a(3)(c), below.

only 16.5 percent and in 1961 less than 19 percent of district 12 members were examined.

Thus, assuming the adequacy of a 3-year cycle, it is quite clear that many member firms are not being examined once every 3 years and that there is an imbalance in coverage among the districts.

(b) *Branch office examinations.*—Although until recently there was no enunciated policy as to frequency of examinations of branch offices,[430] the association actually operates under about a 10-year cycle. This is illustrated by the following table:[431]

TABLE XII–h.—*Branch office examinations by the NASD, 1955–61*

Year	Number of branch offices	Number of branch office examinations	Percentage o branch office examinations
1961	4,519	470	10.4
1960	4,231	515	12.2
1959	3,836	365	9.5
1958	3,242	553	17.0
1957	2,780	130	4.7
1956	2,665		
1955	1,704	8	.5

The infrequency of branch office examinations is even more pronounced in particular districts. In district 12, only 12 branch offices were examined between 1958 and 1961; in 1960 the district reported no branch office examinations. In district 3 (Denver) only 2 branch offices, or 1.5 percent of the total, were examined in 1961; in district 4 (Kansas City), 4 branch offices, or 1.8 percent; in district 11 (Philadelphia), 7 branch offices, or 2.1 percent; and in district 13 (Boston), 9, or 3.1 percent. Earlier years similarly show low branch office coverage in several districts. The generally low coverage stems from the fact that branch offices normally are not included in the scheduling of member examinations, so that such offices may be examined only during the course of mass examinations or in special circumstances.[432]

The need for regular examinations of branch offices, long recognized by association officials, is demonstrated by the high incidence of branch office enforcement problems encountered by the association.[433] In September 1958 the executive director reported to the board of governors:

> The examination program disclosed what appears to be lack of proper supervision in branch offices, accompanied by failure to maintain proper records in those offices, apparently as the result of a tendency to rely almost entirely on the main office for supervision and recordkeeping.
>
> Current examinations of branch offices indicate a pattern of poor supervision with regard to correspondence, markup policies, recommendations to customers, Regulation T and the like.
>
> The difficulties of supervision of a branch office by a member are quite obvious. By the time correspondence and orders are approved in the main office, they have, of course, been mailed or confirmed to the customer. It is the responsibility of the member to establish and maintain proper systems and

[430] In 1962, the executive office informed the study that the association's objective is to examine branch offices every 3 years.

[431] The association has reported that, in 1962, 14 percent of the 4,713 members' branch offices at the end of the year were examined. NASD Annual Report, 1962.

[432] In three of four district offices visited by members of the staff of the Special Study there were no records concerning branch offices located in these districts.

[433] See discussion of branch offices in ch. III.B.

controls that will result in adequate supervision; and there is no hard and fast rule or formula that can assure this—what may constitute adequate supervision in one firm may well be inadequate in another.

(c) *New member examinations.*—The association has recognized that newly admitted members presented special problems and required special attention. It has therefore been the announced association objective for many years to examine all new members within 6 months of admission.[434] The association has not been able to reach this goal.

A survey by the association in January 1961 showed that 521 firms which had been members of the association for more than 6 months had never been examined (specially or otherwise); 410 of these firms have their main offices in district 12 (New York). A similar survey made in May 1962 showed that 601 members of more than 6 months' standing had never been examined.

(4) *Examination procedures*

In carrying out inspections of member firms, the examiner is guided by a standardized report form and a handbook setting forth examination procedures. The form contains a list of topics to be covered in a personal interview with a principal of the firm. Included in the interview are such general topics as the type of business conducted by the firm and nature of the firm's clientele and accounts, and such specific matters as the manner in which the business is financed, nature of any clearance arrangements, safekeeping procedures for customers' securities, commission rate policy on listed and over-the-counter business, identification of the person responsible for supervising correspondence and transactions, nature of the firm's business in the sale of investment company shares, and advertising policy.[435]

The examiner then conducts a general examination of the firm's books and records. After reviewing the material called for in each item on the report form, the examiner indicates on the form whether there has been compliance with the substantive regulations and rules applicable to each item.

Where the member engages as principal in over-the-counter transactions, the examiner is generally required to list on a schedule by trade date a sample of consecutive sales of securities to retail customers in which the member acted as principal. This schedule is used for the purpose of making pricing tests in order to determine the reasonableness of the member's spreads or markups in his principal transactions.[436] On another schedule the examiner records information concerning "proceeds transactions" (i.e., purchases of securities from or sales of securities for customers, where any part of the proceeds is used for sales to or purchases on behalf of customers).

In order to obtain broad coverage of the membership with a small examiner force, the association has been forced to limit the time spent on individual examinations. An association study in 1959 revealed that the average examination of a member lasted 9 hours and of a branch office, less than 2½ hours.[437]

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[434] See ch. II.B.1.b. and table II–2

[435] This is the only form used at present. Thus, it is utilized in examinations of all varieties of firms including over-the-counter retail, wholesale, and integrated houses, mutual fund dealers and underwriters, and exchange commission firms.

[436] See discussion of markups in ch. VII.D.

[437] A Commission examination of a broker-dealer firm usually lasts between 2½ to 3 days.

(a) *Subjects receiving emphasis in examinations.*—As may be expected, examinations of member firms emphasize those areas where compliance or lack of compliance with applicable rules is determinable from a review of books and records. A description of the principal areas covered follows:[438]

(i) *Regulation T.*[439]—The association's examination procedures for checking violation of Regulation T are largely confined to ascertaining compliance with the Regulation's prompt-payment requirements for special cash accounts. Margin accounts are not analyzed.[440] However, since most margin accounts are with NYSE member firms, that agency analyzes them in the course of its inspection. The provisions of Regulation T applicable to special cash accounts require that customers pay for securities purchased within 7 business days after date of purchase unless extensions of time are granted.

The procedures followed by the examiner are outlined in the examiner's handbook as follows:

> The examiner should carefully check the customers' ledger for violations of Regulation T. He should compare with the transactions in the customers' ledger any extensions[441] the member may have, either from an exchange or from an NASD district office. If the transaction had not been paid for within the period of time allowed by the extension, a violation of Regulation T still exists. Examiners should make particular note of those accounts where transactions were cancelled for nonpayment and the account was not frozen for ninety days. This, of course, is a violation. When the examiner finds apparent violations of Regulation T, it is necessary that he record certain types of information about each transaction in question and attach it to the examination report. He should show the customer's initials or other account designation, description of the securities, the total amount, the trade date, the date the transaction was paid, and the number of days in violation.

Violation of Regulation T is the most prevalent charge found in association disciplinary proceedings predicated upon examinations. During the years 1959–61, of the 472 cases arising out of member examinations, 197 contained allegations of Regulation T violations.[442] In 189 of these cases, the charge was sustained.

(ii) *Maintenance of books and records.*—Disciplinary matters involving books and records covered by article III, section 21 of the rules of fair practice make up the next largest category (177 cases

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[438] Other principal areas covered but not described below include compliance with NASD requirements applicable to registration of salesmen, notification of opening and closing of branch offices, payment of assessments, and nonmember dealings. Manual, H–5, 9: "Rules of Fair Practice," secs. 23–25. See table XII–12.

[439] For a general discussion of the substantive requirements in this area see ch. X.C.

[440] See pt. B.3.b(2), above.

[441] Under the provisions of Regulation T either a national securities exchange or a registered national securities association may extend the 7-day period upon application of the securities firm if it is satisfied (1) that the application has been made in good faith, (2) that a bona fide cash transaction is involved, and (3) that "exceptional circumstances" exist. The NASD has delegated its authority for granting extensions to its 13 district committees and all but district 2 (San Francisco and Los Angeles) exercise this authority. During 1962 the NASD processed 27,152 requests, considerably fewer than the NYSE.

It is not the policy of the districts to investigate or otherwise verify the good faith of the requests filed with them and as a result extensions of time generally are routinely granted. Less than 5 percent of the requests made in any given period are denied and most of the denials involve requests which in any event could not be granted since they were untimely. Extensions are often granted for reasons which do not appear to be "exceptional." The most common reasons given are "check in mail," "out of town," "customer on vacation," "customer out of town," and "unable to contact customer." In one district, for example, a single firm received extensions in 427 instances between June 1 and June 25, 1962, when the reasons for these extensions were all "check in mail."

In general, the districts do not make use of their extension files in connection with their enforcement and surveillance responsibilities.

[442] It was found, for example, from district 12 (New York) examination experience that Regulation T discrepancies occur with some frequency. See tables XII–11 and XII–12.

in the years of 1959–61)[443] of those arising out of examinations.[444]

Particularly stressed in the examination is compliance with Commission rules 17a–3 and 17a–4 under the Exchange Act.[445] Rule 17a–3 enumerates specific recordkeeping requirements for maintenance of current blotters; general, customer, and position ledgers; order and sales memorandums; confirmations; margin and cash account records; and monthly trial balances. Rule 17a–4 establishes minimum periods for the retention of books and records.

The handbook does not spell out precisely the procedures the examiner should follow in carrying out this phase of the examination. He is under no affirmative duty to trace entries through the various books of account to determine the accuracy and completeness of the financial and other information recorded.

(iii) *Markups.*—A detailed evaluation of the association's markup policy and its enforcement is set forth in chapter VII.D. The examination program places a relatively high degree of emphasis on this area. In the years 1959–61 there were 128 decided cases involving markups which arose out of examinations.

Certain limitations of the present examination procedures should be noted. Examiners have discretion whether to make an analysis of proceeds transactions, and they rarely do so. They make no routine check to determine the fairness of commissions in agency transactions[446] or of "markdowns" in principal purchases from retail customers. Consequently, the examiner's work in this area is largely limited to preparing a schedule of markups in principal sale transactions. As pointed out in chapter VII, there is some misunderstanding in both theory and practice as to when contemporaneous cost or an independent offer or both are to be considered by the examiner.

(iv) *Net capital impairments and protection of customers' funds and securities.*[447]—Unlike the New York Stock Exchange and other exchanges, the association does not obtain periodic financial reports from its members.[448] Thus, it is generally only during an examination that the financial condition of the member is under scrutiny by the NASD.[449] Compliance with the Commission's net capital rule (rule 15c–3 under the Exchange Act) is an area stressed in the periodic examinations of nonexchange members.[450] One NASD staff member testified:

> A capital rule violation is one of the quickest and simplest determinations to make. It is possibly the most effective rule we have had * * *. We are very sensitive to capital rule violations and we are happy to follow them up.

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[443] See table XII–11. The charge was sustained in 171 of these cases.

[444] It was found, for example, from district 12 examination experience that books and records irregularities have been by far the most prevalent uncovered. See table XII–12.

[445] Sec. 21 provides:

"A member shall keep and preserve books, accounts, records, memorandums, and correspondence in conformity with all applicable Federal and State laws and all rules and regulations promulgated thereunder."

The examiner handbook states, however, that—

"The examiner need not concern himself with State recordkeeping requirements since SEC standards generally exceed State rules, if any."

[446] The results of the survey of firms (through questionnaire OTC–3) with respect to commissions charged in over-the-counter agency transactions are reported in ch. VII.

[447] For a detailed discussion of the controls in this area see ch. III.D.

[448] The Commission obtains annual reports of financial condition from each registered broker-dealer pursuant to rule 17a–5 under the Exchange Act.

[449] At times district committees request firms found to have been in or close to financial difficulty to report periodically their financial condition. In addition, following the May 1962 market break the association requested financial data from all members. This survey uncovered evidence of 113 capital deficiencies, which were reported to the Commission and the appropriate district committees.

[450] Under rule 15c3–1(b)(2), members of the major exchanges are exempt from the provisions of the net capital rule.

In the years 1959–61 there were 102 cases decided in which violations of the net capital rule were charged, 98 of which arose out of examinations.

In making net capital computations, the examiners generally rely upon financial statements prepared by the member. Under association rules, such statements need not be certified (except for statements prepared under Commission rule 17a–5 under the Exchange Act). The examiner normally makes no independent verification of the various items, such as cash, bank loans, and customers' credit balances, appearing on the firm's financial statements. Furthermore, the examination procedures do not call for the examiner to take off his own trial balance. Since in some instances members fail to maintain their books and records on a current basis, the examiner is forced to work with trial balances and other statements sometimes many months old.[451]

The association has a policy of giving prompt notification to the Commission when a possible net capital violation is uncovered. This practice which was worked out many years ago by Commission and association staff members, has produced significant results in preventing customer and member losses.[452]

In its surveillance of the net capital rule, the NASD frequently detects related forms of misconduct. For example, in 1961 the association brought 10 net capital cases against firms which were charged with doing business while insolvent without disclosing to customers that fact.[453] The prohibition of section 19(a) of article III of the rules of fair practice that "no member shall make improper use of customers' securities or funds" was found to have been violated in 13 of the net capital cases brought in 1961.

The association has no procedure designed specifically to ascertain compliance with section 19(a), and an analysis of disciplinary proceedings reveals that violations are usually detected as a result of other circumstances. Most of the 29 section 19(a) cases decided during the year 1961 were connected with inquiries into the firm's financial condition (as noted above) or involved conversion by a registered representative of a customer's funds or securities which was uncovered by the customer or the member itself.

Section 19 also contains two specific provisions intended to protect customers' securities. These deal with hypothecation and lending of securities and are patterned after and in certain respects extend sections 8(c) and 8(d) and Commission rules 8c–1 and 15c2–1 under the Exchange Act.[454] The examiner is required to inspect the current trial balance to determine if there are loans outstanding and, if so, whether such rules are applicable. There have been few disciplinary cases in this area.[455]

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[451] The lack of up-to-date records may well be a reason for the relatively few examination reports in district 12 indicating net capital discrepancies. Examinations for 1959 and 1960 in that district uncovered evidence of at least 59 violations of the requirements relating to trial balances. See table XII–12.

[452] Under sec. 21(e) of the Exchange Act, the Commission is empowered to seek court injunctions to prevent violations of its rules.

[453] This constitutes a violation of the association's antifraud rule. Rules of fair practice, art. III, sec. 18.

[454] See ch. III.D.

[455] The examiner is also required to determine, through discussions with principals of the member firm, whether securities are segregated and identified. See ch. III.D.

(v) *Required disclosures.*—The association's rules of fair practice expressly require that certain disclosures be made in members' dealings with the public.[456] Under section 12 of article III of the rules a member, at or before the completion of a transaction, is required to disclose to his customers whether he is acting as a broker or dealer in the transaction and, if he is acting as broker, the name of the person from whom the security was purchased or to whom it was sold, the date and time of the transaction or the fact that such information will be furnished on request, and the source and amount of any remuneration which the member is receiving in connection with the transaction. The examiners are instructed to check a sufficient volume of copies of confirmations, retained in the member's files, to ascertain whether there has been compliance with section 12.[457] They are particularly instructed to see that the confirmation form in agency transactions contains the appropriate legend, which must include in lieu of actual disclosure the following language:

> Upon request, the date and time of execution and the name of the person (or party or broker) from whom purchased or to whom sold will be furnished.

Disciplinary proceedings involving section 12 have been frequent. In the years 1959–61, of the 77 cases decided under that section which were based on examinations, only one resulted in a dismissal of the charge.[458]

Section 13 of article III of the rules requires a member to disclose, before executing a trade in a security, any control relationship he might have with the issuer of the security. Procedures for detecting violations of the provision are not well defined. The examiner is guided by a general instruction to "learn of any relationships which might conceivably result in control." The precise tests for determining such control relationships rest in the discretion of the examiner. In the years 1959–61, six decided cases involved alleged violations of section 13, in two of which the charge was not sustained. District 12 (New York) did not decide any section 13 case during the 3-year period.

Section 14 of article III requires an association member to disclose any interest he may have in a primary or secondary distribution of the securities which he is selling to his customers.[459] The association has no specific procedures for detecting violations of this provision. In the years 1959–61 no cases were decided under this section.

(vi) *Supervision of registered representatives.*—Section 27(a) of article III of the rules of fair practice provides:

> A member who employs any registered representative shall supervise all his transactions and all correspondence relating thereto. All transactions made by a registered representative with or for a customer shall be approved by a partner, a duly accredited executive, or a branch office manager of such member. Approval shall be evidenced by written endorsement or other record of such transaction, and each memorandum or other record, so endorsed, shall be made a part of the permanent records of such member.

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[456] These rules are based on Commission rules 15c1–4 through 15c1–6 under the Exchange Act.

[457] Rule 17a–3(a)(8) under the Exchange Act requires maintenance of copies of confirmations.

[458] There is also a high incidence of apparent violations of sec. 12 found in examinations. See table XII–12.

[459] See the discussion of over-the-counter distributions in ch. IV.C.2.b.

Of the 167 disciplinary cases decided in the years 1959–61 which were based upon inadequate supervision, 129 (or about 77 percent) resulted from member examinations.[460]

The examiner routinely scrutinizes members' records to ascertain compliance with the written endorsement requirement. The examiner's handbook states:

> Transactions must be supervised and approved. Such approval must be evidenced in writing by endorsement on some original record of the transaction by a duly accredited executive as required by section 27 of the Rules of Fair Practice. In most instances, officers of members will evidence approval of transactions by endorsing or initialing the sales memos. Occasionally, a member will use the confirmation or the daily blotter.
>
> Any failure on the part of the member to physically evidence one of these records or some other original memoranda should be recorded with a full explanation on the supplemental report form.

Although it is a relatively simple matter for a member to comply with this requirement,[461] a substantial number of section 27 cases decided in the years 1959–61 were based upon failure to provide evidence of supervision through an endorsement or initialing.

The handbook also states:

> The examiner should indicate whether correspondence is adequately being supervised. It is important to note that under section 27 it isn't necessary for the duly accredited executive to initial correspondence of the representative.

There is no routine procedure for obtaining details of the firm's practices for supervising correspondence. The association's chief examiner has stated, "I think for the most part, examiners get an idea of the mechanics of it, * * * and not just accept the name of an individual as reviewing correspondence." Disciplinary cases involving this kind of violation are usually based upon mailings by registered representatives of material which violates provisions of the Commission's Statement of Policy with respect to investment company sales literature.[462]

There is also no systematic examination procedure for reviewing member firms' policies and practices for supervising the selling activities of their employees. The chief examiner has described some of the methods used, as follows:

> There would be this type of check, which is * * * undertaken * * * in many instances asking the firm * * *, "Do you ever review an account of a customer or accounts of customers on a periodic basis, to determine whether or not the activity in the account seems to be in line with the needs of the customer?"
>
> * * * * * * *
>
> If they do not, but if they initial the transactions, I don't think that we could say in effect, that that was necessarily a violation of section 27 * * * perhaps it would be a situation where a more detailed review of the customer's ledger might be undertaken in order to see whether or not some of these accounts appeared to be mishandled.

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[460] The 38 nonexamination cases usually involved instances where the firm found that a registered representative had engaged in improper conduct and reported the circumstances to the association. The employer was then brought into the proceeding through a supervision charge in order to obtain jurisdiction to discipline the registered representative. In such cases, the supervision charge against the firm was frequently dismissed. See ch. II.F and III.B.

[461] It should be observed that there is no requirement that the endorsement take place before the transaction is actually effected or confirmed. The problems of branch office supervision arising from the absence of this requirement have already been noted. See subsec. a(3)(b), above. While not of as large significance in main office supervision, the problems are substantially similar.

The association's position on the question of whether the requirement of endorsement applies equally to exchange and over-the-counter transactions is unclear. Some district secretaries limit their review to over-the-counter transactions.

[462] See ch. XI.B and subsec. b(1), below.

(vii) *Churning and excessive activity.*—Association examination procedures require that the examiner review on a test basis a number of customer accounts to ascertain whether there has been excessive trading.[463] Such activity, known as "churning," is prohibited by section 15(a) of article III of the rules of fair practice, which provides as follows:

> No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account,

and by the association's suitability rule.[464]

Enforcement of these provisions has suffered because examiners seldom interview customers unless there has been a complaint,[465] and because district secretaries and examiners are unable to devote adequate time to analyzing accounts for possible violations. In May 1960 both the secretary of district 13 (Boston) and the head of the compliance department recommended that a central clearing desk be established which would have the sole task of analyzing accounts picked by examiners for possible churning. Although the executive director reported later in the year that the executive office had adopted this recommendation and was prepared to assist the secretaries and examiners in their analyses of customers' accounts, such procedures do not appear to have been put into effect.

There have been few disciplinary proceedings in this area. In the 3 years 1959–61 the association found only five violations in connection with discretionary accounts and, as noted in chapter III,[466] only six churning cases were brought under the suitability rule in 1961.[467]

(b) *Limitations of examination program.*—The process for following up leads uncovered during examination of books and records is rather limited. Unless the staff receives a public complaint, customers are rarely interviewed. District secretaries and examiners are under informal instructions not to contact members' customers prior to approval of the district committee or the chairman. A district 12 administrative policy states:

> 1. It shall be the declared policy of this committee that in the ordinary course of examination and investigation of members there shall be no indiscriminate contacting of customers; and
>
> 2. In those instances where it appears necessary that customers be contacted in order to accomplish the overall purposes of the association and effectively enforce its rules, the staff shall be required to submit the matter to the full district business conduct committee or to the exectuive committee for their consideration and thereafter proceed with the contacting of customers only in such manner as specifically authorized and directed by the committee.

Such permission is rarely sought. Futhermore, beyond the member interview at the outset of the examination, little is done to obtain the

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[463] As a part of this phase of the examination, the examiner is also required to determine whether there has been switching in connection with mutual fund transactions (i.e., liquidation of the shares of one mutual fund to purchase shares in another fund on the recommendation of the member). See ch. XI.B.

[464] Rules of fair practice, art. III, sec. 2. For a further discussion of NASD controls in this area, see ch. III.B. The association has no rule requiring that a member obtain written customer authorization for the opening of a discretionary account. Cf. NYSE rule 408. The association is presently considering adpotion of such a rule.

[465] See subsec. a.4(b), below.

[466] Ch. III.B.6(b)(2).

[467] Examinations in district 12, for example, have disclosed few violations of these provisions. See table XII–12.

member's or its representative's explanation of indicated violations.[468] There are no staff procedures for obtaining on-the-record testimony of a firm's principals, salesmen, or other associates other than through a formal disciplinary hearing.[469] There have been few investigative hearings conducted by district business conduct committees and only in exceptional situations.

Association officials have referred on occasion to the fact that the association lacks subpena power. While its inability to compel testimony prevents the association from reaching nonmembers who are unwilling to cooperate, this is not necessarily a limiting factor in many situations. For example, members of the public at times come forward and offer cooperation; issuers and other nonmember corporations will frequently answer inquiries about themselves and their businesses; and there is, of course, no need to subpena association members or their associates. In many cases, the association's failure to use supplemental investigative techniques does not arise from inability to obtain cooperation; it simply means that no attempt is made to do so.

These limitations in the association's procedures for detecting violations have led to incomplete development of facts. Cases that might have been brought have been dropped after limited inquiry, and charges that might have been proved have been dismissed ("not found") because of lack of evidence. In the years 1959–61, 96 of 809 cases decided by the association, or 12 percent of the total, were dismissed. Many of these dismissals have been in cases involving charges such as suitability and fraud, where the need for independent inquiry beyond the member's books and records most often appears.[470] Furthermore, during the years 1959–61, only five NASD disciplinary proceedings involved findings of false and misleading statements relating to the merits of the security or the nature of the market for the security, although, as the Special Study has revealed, such activities are by no means as uncommon as this relative absence of cases might indicate.[471]

b. Substantive areas in which techniques other than member examination are employed

(1) *Mutual fund sales literature and advertising*

The association has the responsibility of administering the Commission's Statement of Policy concerning standards for investment company sales literature.[472] In order to carry out this responsibility, the association requires that all investment company selling material be filed with the investment companies department, either before or within 3 days after its use.[473] Only materials reproduced for public dis-

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[468] The handbook states:

"Should the [member's] representative request [at the beginning of the examination] that he be informed of any deficiencies or problems encountered in the inspection phase of an examination, the examiner should advise him that he will be glad to check with him when he is finished but that it is not his but the committee's function to determine whether deficiencies or any violation exist and what action should be taken."

[469] A board resolution empowers any duly authorized agent of the association to require any member under investigation to submit a report in writing with regard to any matter involved in such investigation. A further resolution provides for summary suspension of a member for failure to furnish information duly requested. Manual, H–2–3.

[470] See table XII–11.

[471] However, the NASD may charge a violation of the markup policy or some other NASD rule or interpretation not involving fraud or manipulation in order to reach some of the more flagrant selling practice cases. See ch. III.B.6.b(2) and ch. VII.D.4.

[472] See 3 Loss, Securities Regulation (2d ed. 1961) 1443–1444; NASD Manual, J–3. See also sec. 3.b(4)(c), above, and ch. XI.B.

[473] The department staff has estimated that two-thirds of all material received is filed before use.

semination or "individually typed sales letters which repeat the theme of the same central idea" need be filed. Other correspondence must comply with the Statement of Policy, and copies of all selling literature must be retained by the firm for 2 years.[474]

There is at present no procedure for ascertaining compliance with the filing requirement. One fund distributor conceded to the study that, although it had submitted certain drafts of proposed materials to the NASD for comment, it had not in any instance filed literature after publication. District examiners are supposed to inspect members' files of sales literature, but since they do not see the department files in Washington, it is difficult for them to ascertain whether the material in it has been filed. The examiner is thus limited to determining whether the literature contained in a member's file conforms to the Statement of Policy and whether a file of literature has been kept as required. The head of the department has indicated that he expects the examiners to pick out only the more obvious violations of the Statement of Policy.

The staff of the department reviews filed literature in order to ascertain whether it complies with the Statement of Policy. Sales literature submitted for review is only occasionally compared with the current prospectus; and in the course of the study, some material discrepancies were noted between the selling literature and the prospectus.

There were 53 decided cases involving the Statement of Policy in the years 1959–61. Enforcement in this area has been facilitated by the fact that the standards of the Statement of Policy are fairly specific. Furthermore, the staff of the investment companies department often assists examiners in reviewing questionable literature or correspondence, not subject to filing requirements or disseminated in violation of such requirements, which is picked up in the course of examinations.[475]

(2) *Free-riding and withholding*

The NASD exercises surveillance over members participating in underwritings for the purpose of ascertaining compliance with its "Interpretation With Respect to 'Free-Riding and Withholding.'" [476] A member of the national office staff maintains a watch over underwritings and periodically furnishes the names of issues showing a substantial price premium in the immediate aftermarket to the executive director, who then reports the information to the executive committee. If the executive committee authorizes, written questionnaires are sent to underwriting and selling group members. Completed questionnaires showing some degree of withholding in firm, insider, or other broker-dealer accounts are forwarded to the district in which the member is located for disposition—i.e., filing without action or institution of formal or informal disciplinary action.

The questionnaire is designed to ascertain from the member the total number of shares allocated to it as underwriter or selling group member; the number of shares allotted to accounts of the firm, insiders, institutional buyers, and other broker-dealers at the public offering

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[474] Manual, G–20.

[475] Executive office review and assistance is not available in review of members' general advertising and sales literature for other than mutual funds. As observed in ch. III.C.8(a)(3), the association relies mainly on the examination program to enforce the broad interpretation of its rules applicable to such literature; its methods have been largely ineffective; and the few disciplinary cases in this area have dealt with the crudest forms of "come-on" techniques and the more flagrant kinds of misleading statements.

[476] Manual, G–23. For a discussion of "free-riding" problems, see ch. IV.B.3.b(2)(f).

price; and particulars of the investment history of insider accounts receiving allotments.

Between the adoption of the free-riding interpretation in 1950 and December 31, 1961, the association circulated over 9,000 such questionnaires covering more than 150 new issues. The number of violations which have been uncovered through the use of the questionnaire points to its being a highly effective detection device.[477]

The association has relied primarily on the questionnaire device for detecting violations of the free-riding interpretation but examination procedures generally call for the examiner to inspect transactions of insider accounts of the firm in securities known to be "hot issues." Special examinations may be conducted where answers on a questionnaire indicate violations of the free-riding interpretation, but these are infrequent.[478]

(3) *Review of underwriters' compensation arrangements*

Procedures to review underwriters' compensation arrangements for new equity issues were instituted in early 1962.[479] Managing underwriters are required to file copies of the offering prospectus with the national office. Questionable cases are forwarded to the Committee on Underwriting Arrangements, which is authorized to comment on the proposed arrangements and to recommend disciplinary action against those members whose arrangements are considered unreasonable and who do not revise them to conform to the committee's standards.

Between January 15, 1962, and September 24, 1962, preliminary prospectuses for 1,201 issues were filed with the national office. Of these, 312 were referred to the committee, which found 150 to be "unfair and unreasonable." In 52 of these issues, the underwriters offered to revise the compensation arrangements, and 33 were thereafter cleared by the committee. Recommendations of the committee for disciplinary proceedings have been under consideration with respect to some cases where underwriters went forward with the offering notwithstanding objections raised by the committee.

c. Areas not generally covered by association surveillance

One of the stated objectives of the association is "to encourage and promote among members observance of Federal and State securities laws.[480] Nevertheless, there are several major areas encompassed by those laws with which the association has not been directly concerned.

The association has no examination or other surveillance procedures for ascertaining whether its members are complying with the registration requirements of section 5 of the 1933 act. Examiners are not required to determine whether distributions by member firms are properly registered, or to obtain a list of securities distributed. In

[477] See ch. IV.B.3.b(2)(f)(ii) and table XII–11.

[478] While the questionnaire generally elicits sufficient information upon which to base a judgment as to whether a violation has occurred, there have been a number of cases where a followup investigation might have indicated that a defense to an apparent violation existed. For example, a significant factor in the relatively high dismissal rate in free-riding cases, particularly those involving offerings prior to April 1960, has been the ability of some respondents to demonstrate in answer to the charges or at the hearing that an allocation to an insider was justified by the investment history of the account. See table XII–13.

[479] See the recommendations in ch. IV.B. concerning the publication of rulings on underwriting arrangements and sec. 3(b)(2)(e)(iv), above. The same committee also reviews intrastate offerings underwritten by members. See ch. IV.D.; Manual, G–59–62.

[480] Certificate of incorporation, art. 3, par. (1).

1959, the district secretaries were advised by the executive director that:

> No action should be initiated by the association in enforcement of section 5 unless they are instructed to the contrary at a later date.

No contrary instructions followed. One district secretary was advised by the executive director in November 1961 that advance clearance from the executive office should be sought before a complaint is brought under section 5.[481] Since 1959 no case predicated upon section 5 has been decided by the association.

The association has no procedures for detecting violation of the antimanipulative provisions of the Securities Act and Exchange Act. The district offices have copies of the National Daily Quotation Bureau sheets but they are used for enforcement of the markup policy and net capital rules, not for the purpose of market surveillance. Counsel to the association has testified that few disciplinary actions are based upon charges of manipulation, but that—

> [W]e might have a case filed based on two or three violations of our rules, where, after we have a hearing, we would see evidence of manipulation. We might wind up—in fact, all we could do would be to find violations of our rules. We can take those other factors into consideration in imposing a penalty. But the manipulation generally develops as the case which was bottomed on violation of our rules is developed.[482]

There are no investigatory procedures for determining the use of the sheets by members or other aspects of the conduct of wholesale trading.[483]

Examiners are not expected to ascertain whether members engaged in trading in connection with distributions of securities are in violation of rule 10b–6 under the Exchange Act.[484] The district 12 (New York) secretary testified that the association has no routine procedures to determine whether or not there have been violations of rule 10b–6, although the staff members who evaluate examination reports "may get an indication that this exists and may then check it out."

Despite the general objective quoted above, the association has adopted an affirmative policy of not enforcing State securities laws. The minutes of the 1959 annual district secretaries meeting set forth the association's position:

> In response to a question regarding the association enforcing State law, Mr. Fulton explained that the NASD has never attempted to enforce State securities laws and the board at its last meeting passed a resolution prohibiting association personnel from furnishing any information regarding complaint activities to State authorities. He pointed out that the State of Pennsylvania has issued over 350 cease-and-desist orders against members of the association and that the association does not enforce these orders.

This position still remains in effect. One district secretary testified as follows:

> Q. If you find violations of State law will you try to enforce them?
> A. So far, I have never; no.
> Q. Have you found any violations?
> A. I have never found any. It has been brought to my attention by, perhaps, newspaper articles but I have never enforced it.

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[481] The minutes of the 1959 district secretaries meeting stated that the question of sec. 5 enforcement would be taken before the board for a policy determination. This does not appear to have happened.

[482] 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., p. 94 (1961).

[483] See ch. VII.C.

[484] See ch. IV.B.3.c(3) and IV.C.

Q. You did not?
A. I have never and I don't think I would.

The Special Study found no association case containing alleged violations of State securities laws.[485]

d. Handling of public complaints[486]

Complaints received from the public have played a comparatively insignificant role in NASD enforcement functions. The primary explanation for this probably lies in the largely self-imposed anonymity of the association and its work. As noted above, association rules and policies restrict member advertising of the fact of NASD membership, and the association itself does little to publicize its activities.[487]

Although there is general recognition by the association that all public complaints should receive consideration and, when warranted, investigation, attitudes toward them have varied. The national office and some district secretaries, usually those receiving some volume of such complaints, consider them to be important as enforcement tools.

Even where there is greater recognition of the usefulness of public complaints in enforcement activity, full advantage has not been taken of them, owing largely to lack of staff assistance. Several district secretaries have found, however, that public complaints often add materially to their fund of knowledge about certain members and thus are of aid in conducting examinations of those firms.

In recent months there appears to have been a noticeable increase in public awareness of the NASD and thus in the amount of public contact with the association. In 1961 district 12 (New York) was the first district to set up a separate docket in order to handle the growing volume of complaints. Moreover, in early 1962 district 12 assigned an examiner to handle public complaints on a full-time basis; nevertheless, a backlog appears to be developing. An increasing number of complaints are being followed up, frequently by interviews with members and registered representatives.

Since the early days of the association, members of the public (as well as association members) have been afforded the right to institute formal complaint proceedings against any member.[488] The percentage of formal complaints emanating from the public, however, has been low. Of the 809 disciplinary proceedings disposed of by district business conduct committees in the period 1959–61, only 28 were based on formal public complaints. Ten of these complaints were dismissed, three were withdrawn by the complainant prior to decision, and only four led to a penalty greater than censure.

There are several explanations for the limited use of formal public complaints. First, association representatives assert that where there appears to be merit to a claim of improper conduct, the business conduct committee often will file a complaint itself; however, the inci-

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[485] See pt. J, below.
[486] See also ch. III.B.
[487] Sec. 3.b(2)(d), above. See also subsec. e(3), below.
[488] Sec. 2 of art. IV of the rules of fair practice states:
"Any person feeling aggrieved by any act, practice or omission of any member of the [association], which such person believes to be in violation of any of the Rules of Fair Practice, may * * * file a complaint against such member in regard thereto * * *, and any such complaint shall be handled in accordance with the code of procedure * * *."
Unlike the NYSE, the NASD does not have a formal arbitration procedure. See pt. B.5, above. A proposed code of arbitration was submitted informally to the Commission in 1944, but the Commission raised several objections to it, and the association thereafter abandoned its efforts in that direction.

dence of complaints arising in that manner is low. Secondly, although NASD staff and committee officials may offer a degree of assistance in the preparation of formal complaints and prosecution of the case, the responsibility for proceeding and carrying the case forward lies largely with the public complainant. Many potential complainants are unquestionably discouraged from going forward by the burdens involved in assuming that role, especially since this procedure will not result in restitution or other benefit to the complainant.

e. The disciplinary process as an enforcement and remedial device

The conduct of NASD disciplinary proceedings is governed not only by rules of the association but also directly by provisions of Federal law. Section 15A of the Exchange Act requires that the rules of any national securities association registered thereunder provide that members be disciplined for any violation of its rules; that in disciplinary proceedings there be "a fair and orderly procedure," the bringing of specific charges, notice to the member and an opportunity to defend; that a record of such proceedings be kept; and that determinations include a statement setting forth findings of fact, the specific rules violated, whether the member's conduct is deemed inconsistent with just and equitable principles of trade, and the penalty imposed.[489] The statute also provides for Commission review of such disciplinary proceedings, on its own motion or upon application of any person aggrieved.[490]

The following subsections will discuss three important aspects of NASD disciplinary proceedings: degree of formality, severity of the penalties, and publication of results.

(1) *Degree of formality*

Throughout its history, the NASD has placed great emphasis on informality and simplicity in all phases of the disciplinary process. It has held the rules of evidence to be inapplicable to its proceedings and has endeavored to keep its complaints and decisions as brief as possible. Nevertheless, procedures have become more and more formalized.[491] The association's basic rules have with few exceptions been applied and construed in a vast number of cases, and precedents have been established.

The executive director has expressed concern with the trend toward formality:

> As the association grows older, there is a tendency to become more legalistic and to get away from the direct and simple procedures envisioned by the framers of the legislation. We should constantly keep in mind that simplicity—both in the making of a record and the writing of decisions—is all important. If we fall into the habit of having decisions written by lawyers, in lawyers' language, we will, I believe, be establishing a precedent which will be harmful. Should we allow our processes to become legalistic, we would sooner or later develop to the point where strict adherence to the rules of evidence and all of the other formalities of the law would be in order. This we are not required to do and we should always be on our guard that we do not become involved in these complications.
>
> A member is entitled to a fair hearing, during which all of the pertinent facts relating to the complaint should be brought out. He is *not* entitled to all of the delays which lawyers are many times successful in obtaining from the courts,

[489] Exchange Act, secs. 15A(b)(8)–(9). The code of procedure, secs. 15–16, contains the required association rules. Right to counsel is specifically provided for.

[490] Exchange Act, sec. 15A(g). See pt. I, below.

[491] This is illustrated by the fact that there are forms for complaints, decisions, introductory remarks of chairmen of hearing committees, and for other similar matters.

nor is he entitled to a strict observance of the rules of evidence. Fairness should be the keynote, coupled with scrupulousness in obtaining the facts upon which the decision is based. But uppermost in the minds of all members of district business conduct committees and the National Business Conduct Committee should be the fact that finally the decision is made by businessmen based upon their knowledge of the procedures of their business. [Emphasis in original.]

The Commission has recognized the need for informality in NASD disciplinary proceedings. As early as 1944, the Commission stated:

To speak of formal burdens of proof in the context of a disciplinary proceeding held before a committee of the NASD may appear somewhat overtechnical, since the proceeding is heard by the accused member's fellow businessmen who are supposed to bring their knowledge of trade practices to bear upon the case, and make their determination in the light of their experience as technicians in the securities markets rather than as lay jurors or legalistic judges.[492]

In general, in reviewing NASD disciplinary proceedings, the Commission has applied the test of whether prejudice has been demonstrated, rather than whether there are potentialities of abuse in the procedures employed. Where the question of the multiple roles of the staff in the investigation, prosecution, and decision of disciplinary actions has been raised on appeal, the Commission has declined to sustain objections on this ground in that "we find nothing in the record to indicate that the district committee delegated its decisional functions.[493]

The substantial increase in the time consumed in disposing of cases, particularly in recent years, has already been noted.[494] The possible impact of long delays on the remedial value of a case was pointed up by a district chairman in February 1962:

Due to the increasing number of offenses and complaints, the backlog of unprocessed work has resulted in a situation where a complaint may not be processed for a year. This permits those committing serious offenses to continue malpractice for a needlessly long period of time. I feel our staff should be expanded to permit a more efficient and less time-consuming method of determining cases.

(2) *Penalties*

Any district business conduct committee or the board may impose penalties of censure, fine not in excess of $1,000, suspension of membership or registration (of a registered representative for a definite period, and/or expulsion from membership or revocation of registration, for each violation of the rules of the association.[495]

From its inception until December 31, 1961, the NASD expelled 249 members, revoked the registration of 261 representatives, suspended 70 members and 64 representatives, censured 860 members and 191 representatives, fined 839 members and 157 representatives, and collected fines totaling $599,388. A significant percentage of such actions occurred in recent years. In the 5-year period 1957–61, it expelled 163 members, revoked 206 registrations, suspended 48 members and 49 registrations, censured 605 firms and 185 representatives, and fined 596 members and 138 representatives.[496]

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[492] *In the Matter of National Association of Securities Dealers, Inc.*, 17 S.E.C. 459, 469.

[493] *Gerald M. Greenberg and Robert Leopold*, Securities Exchange Act release No. 6320 (July 21, 1960). Accord, *Palombi Securities Co., Inc., et al.*, Securities Exchange Act release No. 6961 (Nov. 30, 1962).

[494] See sec. 3.c(3)(a), above. For the association as a whole in 1961, the average elapsed time between examination and decision was 318 days and between complaint and decision 218 days.

[495] Rules of Fair Practice, art. V, sec. 1. The limit on fines was raised from $500 to $1,000, effective Aug. 1, 1960.

[496] Includes minor violation proceedings. The aggregate fines assessed are much greater than the amount collected since expelled members and representatives whose registrations are revoked rarely pay their fines. The figure for fines assessed was not available.

A study of the cases decided in the years 1959–61 reveals that the association imposes particularly severe penalties for certain kinds of member misconduct. The NASD has long treated violations of the Commission's net capital rule as especially serious. In the 3-year period, district business conduct committees decided 16 cases in which the only charge involved violations of the net capital rule and in 7 of those cases the member was suspended or expelled from the association. Of the 142 district cases for that period in which the member was suspended or expelled, a net capital charge was included in 71.

Firms engaged in boiler-room types of activities are rarely disciplined by the association as a result of formal allegations of high-pressure, fraudulent selling;[497] but, where more easily proven violations have been charged and found, the board and district business conduct committees, in considering the appropriate penalty, often have taken cognizance of the general nature of such a firm's method of conducting business and expelled the member.

The picture is quite different when it comes to free-riding cases. Although there were 445 cases in the period 1950–61 based solely upon the free-riding interpretation in which violations were found, no member has ever been expelled and only two suspended for such conduct.[498] In one of the suspension cases the member's potential profit on the shares withheld in insider accounts was about $63,000. Since there were only two rule violations alleged in the case, the district business conduct committee apparently felt it necessary to observe:

> In arriving at a proper penalty to be assessed in this matter, we have taken into account that the rules of fair practice place a limit on our ability to fine the respondent of $500[499] for each of the two violations charged in the complaint and here found.

As a result, a 10-day suspension from membership was also imposed. In the other case involving a suspension, the association found violations of the free-riding interpretation in distributions of 25 new issues, and the respondent and another member employed a fictitious account in an attempt to circumvent the interpretation.[500]

The relative leniency which the association has exhibited in free-riding cases is significant because this kind of violation, unlike net capital violations, is not found primarily in marginal firms. Of the 279 cases decided by the NASD in the period 1959–61 which were based solely upon free-riding, 118 involved New York Stock Exchange member firms.[501]

(3) *Publicity concerning disciplinary proceedings and rules of conduct*

Aside from the parties to disciplinary proceedings, national and district officials and the Commission are the only recipients of the full texts of association decisions and all treat them as nonpublic mate-

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[497] See ch. III.B.
[498] See also ch. IV.B.3.b(2)(f)(ii).
[499] See note 495, p. 665.
[500] The case also involved violations of Regulation T in the fictitious account, but since these charges were based on the same transactions as some of the free-riding charges, the case was placed in the "free-riding alone" category for the purpose of the above analyses. The fictitious account device was not alleged as a separate violation as has been done in more recent cases. See ch. III.B. The use of that device generally has been dealt with very severely, particularly with regard to the registered representative involved. See, for example, "Leonard H. Zigman," Securities Exchange Act release No. 6701 (Jan. 5, 1962).
[501] See table XII–13.

rial.[502] Until the time of writing this report only expulsions were publicly announced through the press, under association policy.[503] Members are notified of suspensions and expulsions of members and revocations of registered representatives through a "special notice" mailed immediately after the order becomes effective, which states the type of violations found and the rules violated. A formal notice of suspensions, expulsions, and revocations is included in the next published supplement to the List of Members furnished to the membership. Case summaries very similar to those contained in the special notice appear in the supplements to the NASD manual which all members generally have and which is regarded as a semipublic document.[504]

A fairly typical summary of an NASD disciplinary decision (i.e., explusion) as contained in its press releases reads as follows:

> [The company was expelled] for selling securities to customers at prices which were not fair and not reasonably related to the current market, for making unreasonable recommendations to customers through its salesmen, for filing fictitious quotations with another member, for violating Regulation T of the Federal Reserve Board, for failing to register certain individuals and for failing to maintain and keep current proper books and records.

The special notices and manual supplements are similar in form and content. The supplements to the List of Members show only the name of the firm or registered representative and the fact of suspension, expulsion, or revocation. The NASD News, which is disseminated to the membership and such others as attorneys, State administrators, industry organizations, and libraries, summarizes leading association cases and provides discussion of certain novel or otherwise noteworthy problems encountered in recent cases. Some NASD News articles have contained brief descriptions of the actual facts of cases and of the principles involved. These case summaries cover only a very small fraction of all the decided cases. In the period 1959–61, only 9 of the more than 200 board and 809 district business conduct committee decisions were publicized in the NASD News.

Although, in deciding association cases, a great deal of reliance is placed on precedents, the only precedents available to members or their attorneys are the relatively few Commission opinions reviewing NASD cases. The summaries of decisions in the NASD News are generally of limited value to a respondent desiring to demonstrate on appeal to the board of governors or the Commission that, in the light of previously decided NASD cases, the decision rendered was improper or the penalty assessed against him was "excessive or oppressive."

The membership at large is faced with somewhat similar problems. Members have had difficulty in applying certain of the standards set forth in the rules, policies, and interpretations contained in the NASD manual. For example, in recent years, members of the board of governors and district committees have expressed concern about the lack of rank-and-file understanding of the free-riding interpretation and have devoted a great deal of time and effort in trying to clarify several

[502] NASD policy on this subject is contained in the manual, H–9–10.

[503] This policy was introduced in 1957. See the discussion of the recent change in NASD policy concerning the publicizing of disciplinary actions against members and registered representatives in sec. 6, below.

[504] The practice of including a short description in the manual of the type of conduct giving rise to the suspension or expulsion began in 1956.

of its terms.[505] Although factors other than lack of publicity of disciplinary proceedings are involved, it is worthy of comment that of 211 association disciplinary proceedings decided in 1959–61 involving the free-riding interpretation, only 1 was summarized in the NASD News,[506] and that summary consisted of a discussion of the Commission's public release in July 1961 announcing its affirmance of the board decision in the *First California* [507] case, the first Commission decision reviewing an NASD free-riding case.[508]

f. General industry surveillance and quasi-legislative activities

(1) *NASD methods of detection, study, and analysis of industry problems*

Since the members of the NASD are themselves engaged in the business being regulated and since its membership encompasses virtually all of the significant business segments, there exists in the association a kind of "built-in" surveillance which makes it aware of problems.[509] In theory, this provides a major justification for self-regulation and indeed for a maximum degree of member participation in association work.

In addition, the association has for many years sought to secure an interchange of information and discussion of industry problems. The desirability of frequent communications between the district and the national organizations has long been recognized. It has been the practice for the executive director and the chairman of the board each year to tour the country and meet with district committee members and district secretaries. There have also been annual meetings of all district secretaries. The chairmen of the district committees attend one of the three board meetings during the year. While such practices have served several useful purposes, such as educating the districts on national policy and promoting greater uniformity among the districts, a principal advantage has been the opportunities they afford for exchange of information concerning industry problems.

General surveillance at the national level, as has been noted, is carried out by the board, its specialized standing committees, and their staffs. For example, the board, at an early stage, took cognizance of such general issues as variable annuities, part-time dealers and employees, "fails," and entrance qualifications. The Investment Companies Committee had under discussion in their initial phases such problems as reciprocal business and equity funding.

Of material importance in this area has been the association's day-to-day liaison with the Commission. The executive director and other principal members of the executive office staff have provided the major association impetus to this relationship. Of less significance have been the relationships of the NASD with State enforcement authorities and the national securities exchanges.[510]

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[505] See also the discussion in ch. VII.D concerning confusions and misunderstandings with respect to interpretation and application of the NASD markup policy. Some of these problems were reported to the board in 1959 by a special committee. On the basis of that report the 1960 revision of the markup policy was adopted; but only one association markup case decided after the issuance of the report ("Midland Securities, Inc.," Securities Exchange Act release No. 6413 (Nov. 16, 1960)) was written up in the News.

[506] A case involving "reciprocal free-riding" by two firms was also mentioned in this issue of the News but few of the details of the free-riding violations appeared.

[507] Securities Exchange Act release No. 6586 (July 6, 1961).

[508] See discussion of publicity of NYSE disciplinary actions in pt. B.3.c(4), above. The public interest considerations referred to there would seem to have applicability to the NASD as well.

[509] See pt. I, below.

[510] See pt. J, below.

(2) *Policies and standards*

In formulating policies and standards to deal with new problems, the NASD has many positive accomplishments to its credit. The association, for example, has been particularly active in seeking to raise the qualifications for entry into the business. In 1942 the association proposed an amendment to its bylaws to require a minimum net capital of $5,000 for members dealing directly with the securities and funds of the public, and $2,500 for those who settled contracts through a bank or another member without receiving securities or funds of any customer. The Commission disapproved the proposal on the ground that a requirement for minimum net capital did not constitute an appropriate basis for determination of membership under section 15A(b)(3) of the Exchange Act.[511] In 1946 the association instituted procedures for registration of salesmen and 10 years later it amended its bylaws to add three new grounds for disqualification from membership in the association as part of a continuing program designed to elevate the standards of entry into the business.[512]

The NASD has taken leadership in developing the concept of "suitability" of particular securities for particular customers. Unlike the NYSE, the NASD has a rule requiring that recommendations made by a salesman be "suitable" for a customer upon the basis of any facts disclosed as to the customer's "other security holdings and as to his financial situation and needs." In this connection, it is recommended in chapter III that both the NASD and NYSE provide further definition of the content of the concept of suitability and undertake effective surveillance enforcement in this area.[513]

In December 1961, the association instituted a program for review of underwriting arrangements in connection with offerings of new equity issues.[514] Actually, the NYSE had taken the first move to deal with inordinate underwriting compensation, but the NASD proceeded to assume primary responsibility in this important and troublesome area. At about the same time, the association also instituted a program for reviewing intrastate offerings underwritten by its members.[515]

The above enumerations of accomplishments of the NASD is not intended to be exhaustive but is sufficient to demonstrate the NASD's capacity for taking effective action on its own initiative in areas calling for regulatory action. In other instances, however, the NASD has acted only after external prodding or has failed to act at all. Previous chapters of the report have described two principal areas of NASD activity; namely, the "markup" policy and the "free-riding" policy, both of which were adopted by the NASD as responses to imminent Commission action.[516] This pattern of response to impending Government action has been evident on other occasions.

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[511] *In the Matter of National Association of Securities Dealers,* 12 S.E.C. 322 (1942). See ch. II.B and the recommendations in pt. F of that chapter.

[512] See ch. II.B and II.C. The NASD has strongly endorsed the legislative proposals of the Commission designed to raise the standards of qualifications for entry into the business. See "Hearings Before a Subcommittee of the Senate Committee on Banking and Currency on S. 1642," 88th Cong., 1st sess., pp. 65–75 (1963).

[513] See ch. III.B.

[514] See ch. IV.B.

[515] See ch. IV.D.

[516] See ch. VII.D for the background of the "markup" policy and ch. IV.B for the background of the "free-riding" policy.

In 1948, the Commission, concerned with abuses in selling literature and advertising employed in the distribution of investment company shares, issued a release expressing its views with regard to the propriety of certain graphs and charts used to summarize investment company performance.[517] The NASD held a series of conferences with the Commission's staff in the months that followed, and in March 1949, a mutually acceptable form of chart for presentation of such data was developed. Other problems remained and the Commission requested association consideration of them. As a result, a joint investigation of investment company selling literature was undertaken and in October 1950 the Commission adopted, with NASD concurrence, its "Statement of Policy." [518] The association assumed the task of administering the Statement of Policy as to its members. The Investment Companies Committee set forth its reasoning in recommending that action as follows:

> It is our opinion that the investment company industry has attained a size which makes it necessary to exercise a greater amount of self-regulation through this association or submit to greater regulation by Federal and State authorities. We believe that self-regulation is the more desirable and we are hopeful that if it is undertaken in a spirit of cooperation by underwriters and dealers, substantially all of such abuses as may now exist can be eliminated in 1950.

On occasion, the NASD has not acted even after prodding by the Commission. For example, the executive director reported to the board in May 1955 on the regulation of members' selling literature:

> * * * I have had discussions on the problem with the * * * Commission. * * * It is their suggestion that this association immediately undertake to develop standards for advertising and other literature used by members to promote the sale of all types of securities, including those offered under Regulation A.
>
> It is their further suggestion that these standards be set forth in a Statement of Policy comparable to the Statement of Policy now governing investment company shares, and that it be issued and administered unilaterally by the business, rather than by the Government. Their view is that the NASD and the Exchanges will do a better job than Government with less personnel and at less expense. * * *
>
> There is, in view of the Commission and of many in Congress—and I am forced to agree—a wealth of advertising, which is misleading and harmful, both to the uninitiated investor and to the welfare of the securities business. Its elimination should be a duty of the membership.

In late 1955, nevertheless, the board rejected the Statement of Policy approach in favor of a very general rule interpretation which, with slight modication, remains in effect today.[519] This action has not been very effective, owing to inadequate enforcement and the absence of detailed standards of conduct.[520] Association reluctance to adopt specific standards apparently stems from concern that such action might inhibit merchandising activity.

Commission staff members have urged that the association expand the scope of its present sales literature interpretation. It was sug-

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[517] Securities Act release No. 3281 (Apr. 2, 1948).

[518] See sec. 5.b(1), above. In addressing the Mutual Fund Sales Conference in New York later that year, a member of the Commission summed up the matter:

"And right here I want to make two points clear to you: one, that had the industry, through the NASD, *not* intervened in this situation [supplementary literature used by investment companies] and worked with the Commission on a cooperative basis to find a reasonable and workable solution, the sanctions the Commission was considering invoking would have had a far more drastic, far more restrictive effect than the new standards for the future that have been set up. There should be no doubt about this. Unquestionably, the NASD, on behalf of the industry, by working with us and volunteering to undertake curative action as a measure of self-regulation, has rendered you a real service. It could have been worse, gentlemen, of that I assure you." [Emphasis in original.]

[519] Manual, G–19–20.

[520] See ch. III.C.

gested in early 1961 that, as a start, the present interpretation be broadened at least to pick up and make applicable to association members, where appropriate, the provisions of Commission rule 206(4)–1 under the Investment Advisers Act. To date, no board action has been taken.[521]

Some important areas of over-the-counter activity have barely been touched by NASD regulatory activity. Such matters as the firmness of quotations, the use of the interdealer quotations system, the supervision and compensation of traders and other matters relating to the conduct of wholesale trading have largely remained outside the scope of NASD regulation.[522] There are other areas where the NASD purports to exercise regulatory authority but where its existing standards or programs are inadequate in the study's view, as discussed elsewhere in the report. Examples are the association's regulation of retail quotations and the execution of retail transactions.[523]

6. RECENT DEVELOPMENTS

Since the commencement of the Special Study, the NASD has initiated or modified various programs, rules, and policies. Wherever possible, these developments have been noted in this and other parts of the report, although many were of too recent vintage to be adequately assessed. Certain of the more important developments are summarized in this section.

Perhaps the most noteworthy recent step taken by the association has been its undertaking to review, analyze, and revise its bylaws, rules and interpretations. Authorized by the board of governors in September 1961, this project is the first of its kind in the organization's 24-year history. The work is still in progress, and material revisions of many of the association's standards may result. Revisions are contemplated which would expand the association's jurisdiction over the conduct of its members and strengthen its rules and interpretations, particularly in the area of selling practices. Many of these changes have been tentatively approved by the board of governors and discussed informally with the Commission staff.

The association has also effected important organizational changes and has modified or augmented certain of its budgetary, enforcement, and regulatory policies and practices.

Budgeted revenues and expenses have been substantially increased. The budget for fiscal 1963 provided for a 24 percent increase in expenditures over fiscal 1962. The 1963 budget provided for 163 employees, an increase of 33 over the number employed on December 31, 1961, and 51 over December 31, 1960. Specifically, the budget included provision for the following additional employees: 10 examiner-investigators; 3 reviewers of underwriting compensation; 1 attorney; 2 persons to handle complaint proceedings and inquiries from the public in the New York office; 5 persons to assist in quotations and uniform practice matters; an assistant to the comptroller; and several other supervisory employees.

To meet these additional expenditures the association made substantial upward adjustments in its assessment and fee schedules. The

[521] Ibid.
[522] See ch. VII.
[523] Ibid.

basic membership fee was increased by 54 percent, the personnel fee by 50 percent, and underwriting fees by 25 percent. In addition, the overall ceiling on assessments was raised by 25 percent, from $8,000 to $10,000, and the rates for nonassessment revenue items were increased in some instances by as much as 50 percent.

This pattern will continue in the next fiscal year. The association's 1964 budget, approved in June 1963, provides for expenditures in excess of $3 million for the first time in association history; and further upward adjustments again have been made in the assessment and fee schedules to support the increased expenditures. The budget provides for an additional 10 employees including 5 examiners. The membership assessment will be raised by an additional 50 percent, the personnel assessment by 40 percent, and underwriting fees by 25 percent. Substantial increases in the service fees will also be made including a doubling of the branch office fee. Finally, the overall ceiling on assessments and the individual ceilings for personnel and underwriting assessments will be raised to $12,500 and $10,000, respectively.

During calendar 1962 the examiner staff of the association was placed under the general direction of the chief examiner, a newly created position, and steps were taken to make permanent assignments of examiners to all of the 13 districts. Prior to January 1, 1962, 9 of the 13 districts were without permanent examiners. Partially as a result of these changes the association has been able to obtain broader examination coverage of its membership. Thus, the number of member main office and branch office examinations in 1962 was increased 16 and 29 percent, respectively, over 1961.

The association also has begun a program to improve its surveillance of firms engaged in mutual fund distributions, including the establishment of a specially trained group of examiners to implement it.

More disciplinary actions were initiated and decided in 1962 than during any other year in association history. The association found 75 percent more violations of its rules, dismissed 20 percent fewer complaints, expelled 27 percent more members, revoked the registrations of 61 percent more registered representatives, and suspended 50 percent more members and 220 percent more registered representatives than in 1961.

At the time of writing this report the NASD announced a change in its policy concerning the publicizing of disciplinary actions. Under the new policy, the NASD will announce through the press suspensions, as well as expulsions of members, and revocations of the registrations of individual salesmen, after periods of appeal within the association have expired.[524]

The association introduced a new qualification examination for registered representatives, which became effective January 1, 1962; in November 1962 the score required to pass the examination was raised, with the result that the rate of failure increased from less than 1 percent to about 33 percent. The association has prepared and published a study guide for the new examination which can be used either in home study courses or in classroom-conducted training programs. In late 1962 the association also prepared a special examination for new

[524] Manual, H–10.

principals and officers of member firms which may go into effect in the near future.[525]

Several developments outside the regulatory sphere deserve mention. The association has sponsored the organization of the National OTC Clearing Corporation.[526] When in operation, the corporation will provide a clearance facility for transactions in over-the-counter securities in the New York metropolitan area. The corporation hopes eventually to expand its coverage.

In September 1961, in a reversal of a 1959 decision, the board of governors appropriated $50,000 to have the Wharton School of Finance of the University of Pennsylvania conduct a comprehensive study of the over-the-counter markets. This would update the series of studies made by the Wharton School for the association in the early 1950's.

The association's retail quotations program has also undergone numerous changes. For example, the National Quotations Committee has assumed supervision over the activities of the various local quotation committees. Under a new committee policy, companies whose securities appear on the national and regional lists are now required to have policies providing for prompt public notice of all corporate developments "which may affect the value of the company's securities or affect investors' decisions."

At the district level, renewed interest has been generated in having local membership meetings. Five districts held such meetings in the summer and fall of 1962 and these were well attended. In some instances State securities officials were invited and participated in these meetings. As a further effort in public and member education, the association recently commenced preparation of a speakers' guide and other materials designed in part to assist members in their efforts to acquaint investors and industry with the role and functions of the association.

7. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The NASD began as a somewhat unique experiment in supervised self-regulation and, at the outset, had relatively small overall influence in the regulatory pattern. It has emerged 24 years later as an established part of the regulatory scheme exerting a substantial influence on numerous phases of the securities industry.

While this report is, in many respects, critical of its performance, the NASD has many important accomplishments to its credit, and its history evidences a clear desire to expand the role of self-regulation in the total regulatory scheme and to make self-regulation work. Some of the problems of self-regulation on the part of the NASD such as delays in administrative proceedings, backlogs in investigations, and inadequate staff have, of course, had their counterparts in the Commission's performance of its regulatory role.

Over the years, the NASD's policies and rules have multiplied and now deal with many aspects of the securities business. In enforcing its standards of conduct, the association makes over 1,700 special and routine examinations of its members annually, covering a wide variety

[525] See also ch. II.
[526] See ch. III.E.

of subjects relating to the business of its members, and it institutes more than 450 formal complaint proceedings in a year. It also engages in various other activities of a regulatory nature, such as review of underwriting compensation and mutual fund selling literature. Another significant function of the NASD, outside of the strictly regulatory sphere, is the dissemination of retail quotations.

In spite of this record of accomplishment and expansion, or perhaps because of it, the NASD now appears to be at a crossroads. This report points out many important respects in which its activities should be further expanded or its performance of existing activities should be strengthened, yet even without these added burdens it is clear that its capacity to do its job is overtaxed.

The causes seem to lie in its fundamental organizational concepts and arrangements, as related to the responsibilities imposed upon it. The NASD's job of self-regulation is an enormous one in every dimension, but from the beginning it has sought to adhere to a concept of self-regulation with maximum emphasis on "self"—members in the securities business regulating themselves—and with minimum reliance on a full-time paid staff. This concept is applied in every aspect of the association's work, not merely in areas of policy but also, and most pointedly, in the area of complaints and disciplinary actions against members.

The latter area is a uniquely difficult one in both quantity and quality. Its uniqueness stems from the fact that the association is virtually all embracing—there is practical economic compulsion on most broker-dealers to join and legal compulsion on the association to accept them. From the association's point of view this means, unless and until standards for entry into the securities business are substantially raised, that it must take self-regulatory responsibility for the conduct of members of diverse standards and competence. From the members' point of view, on the other hand, the compulsory feature calls for scrupulous fairness when members' conduct is called into question; in practice this has meant that, although proceedings are handled locally in the first instance, appeals may be carried to the highest national level, that is, the board of governors.

At all levels, although staff assistance is used, hearing and decision is by members, that is, part-time volunteers serving this and other needs of the organization. At the district level this has produced severe strains, delays, and compromises. At the national level it threatens a breakdown in the capacity of the organization to act promptly and—an even more serious problem—its capacity to deal adequately with important questions of policy and program. There is now such preoccupation with disciplinary matters, in addition to matters of internal administration, that little time is left for the top governing officials to perceive and solve larger questions.[527]

"Time" is the keyword, the time of volunteer members. There are limits on the amount of time that any individual in the securities business can afford to devote to association affairs. The chairman is called upon to make the greatest sacrifice, and the demands of the office have been such that, even apart from other reasons, a single 1-year term has

[527] For example, in 1962 the board decided 115 disciplinary cases, 75 of which had been appealed by respondents and 40 of which had been called up by the National Business Conduct Committee. In that year, the association closed a total of 486 cases. See sec. 3.b(2)(b), above.

been the pattern. The demands on other members of the board of governors are obviously less and they have 3-year terms, but here another limitation applies: the organization is nationwide and the board has nationwide representation. Thus it is necessary to assemble the governors from their several places of business in order for them to meet as a board. In recent years this has occurred three times a year, for 3 days at a time, a total of 9 meeting days annually.

The problem of time also has another aspect; namely, that the many small member firms ordinarily cannot afford to allow their principals to take major roles in NASD affairs. This is reflected in the composition of district and national committees and the board of governors, particularly the latter; for example, a majority of members of the board are from large NYSE member firms, not as a result of any constitutional provision and apparently not by design but largely on the practical ground of their relative availability. Another factor affecting composition of the board that is of constitutional origin may be mentioned here: Because governors are elected by districts, with only the three largest ones having more than one governor, and the remaining districts selecting a representative only once every 3 years, it has been difficult to have continuing representation of the various important types of business conducted by members.

As the organization has grown and its business has expanded, the association has endeavored to keep pace by bringing more individual members into active participation in its affairs, especially at the district level. But this has increased the responsibilities imposed on an already inadequate staff. The essentially unsolved—and gradually worsening—problem of the NASD is to find a mode of functioning effectively while not unduly sacrificing its emphasis on the "self" in self-regulation. The solution of this problem, it is believed, will require substantial rethinking as to (1) the composition and role of the full-time staff in relation to the role of the volunteer officials, and also as to (2) the allocation of responsibilities among volunteer member participants.

(1) With regard to the composition and role of the full-time staff, it is pertinent to refer briefly to the NYSE. The NYSE and the NASD obviously are not comparable institutions, yet in their strictly self-regulatory aspects comparison is not completely out of order. Some indication of the difference in their equipment is the Stock Exchange's staff of some 226 individuals engaged primarily in regulatory activities, headed by a full-time president, an executive vice president, 8 vice presidents and 9 directors of departments, as against the NASD staff of some 130 full-time employees headed by an executive director and his assistant, three secretaries of members' committees, a house counsel, and 14 district secretaries.[528]

It is obvious from these facts alone that the NASD's conception of the role of a staff in the self-regulatory process is quite different from that of the Stock Exchange. It must also be concluded, without any criticism of individuals making up the staff, that the NASD version is inadequate except on a theory that the staff's role should be minimal, both in quantity and in responsibility, as compared to that of volunteer officials. As early as 1938 the NYSE went over to a system that deem-

[528] The cited figures for both the Stock Exchange and the NASD are as of the beginning of 1962. The NASD has 13 districts but district 2 has two district secretaries, 1 in San Francisco and 1 in Los Angeles.

phasized the role of member committees and increased the role of the permanent staff, headed by a full-time president as chief executive officer. The Amex has made similar changes in slower stages, the latest occurring in 1962 and still in process. The Midwest Stock Exchange has had a full-time president for some years. It seems obvious that the time has come, if it has not been long overdue, for the NASD to have an executive staff of adequate numbers and with adequate delegation of responsibilities. Only in this way can there be found any real hope for carrying the workload, in view of the inherent limitations on the time that can be devoted by members actually engaged in business. Moreover, only in this way is there any chance of assuring the continuity of program and administration that cannot be achieved through volunteer part-time officials elected in 1-year or 3-year cycles.

The creation of a larger staff with larger responsibilities should not weaken the fabric of self-regulation—even with the NASD's special emphasis on "self"—but should serve to strengthen it. Obviously such a staff would work under the board of governors, not above it or apart from it. The fundamental point is that the enlarged staff, under adequate executive direction, could take over tasks that now are neglected or that excessively preoccupy the attention of the elected officials. It could also provide continuing assistance to the elected officials in dealing with the larger questions of policy and program to which the latter would be devoting greater attention than at present.

In the disciplinary area specifically (apart from other possibilities mentioned below) the staff might be expected to play a larger role in the processing of cases down to the point of actual decision and assessment of penalties, which would presumably always be by members in the securities business. For example, district business conduct committee determinations as to whether formal or informal disciplinary action is to be taken might be aided and expedited if staff recommendations were obtained regularly, instead of irregularly and infrequently as at present. Also, the various district processes for review of examinations and other investigative reports to consider the institution of disciplinary action should be backed up by an effective system of national office oversight, so that such district action, when inconsistent—as it often is at present—with national policy, can be corrected at an early stage.

For the longer term, when the staff has grown in size and experience, consideration should be given to granting to the national executive office, on the basis of investigative reports reviewed and filed with it by the district secretaries, the authority to file formal complaints. A further objective for present or future consideration might be the employment in the districts of permanent hearing officers, in lieu of or in addition to member panels, to conduct hearings and prepare recommended decisions for the full business conduct committees. Again, the principal purposes of these possible modifications of the existing system would be to relieve volunteer committeemen and panel members of a large part of their current enforcement burden and at the same time promote conformity with national policy. Moreover, adoption of the latter practice would also tend to carry with it, as a not insignificant byproduct (which, in any event, should be pursued in its own right), a greater separation of those actively engaged in investigating and developing cases from those involved in decisionmaking and thus enhance the basic fairness of the disciplinary mechanism.

(2) With respect to the allocation of work among member participants in the government of the association, several possibilities should have early and serious consideration. First, the board of governors, as such, should be relieved of participation in individual disciplinary proceedings to the greatest extent possible. This might be accomplished by giving final authority at the national level to an entirely separate business conduct committee, or preferably to such a committee made up of a limited number from the board and a larger number of separately elected members. On a purely discretionary basis, the board itself would review only those cases involving a novel principle or an important change from previous expressions of policy. It would, of course, as in all other areas, have ultimate responsibility and authority as to questions of administration and policy in the disciplinary area.

Secondly, the role of "substantive" committees, such as the Quotations Committee or the Investment Companies Committee, should be clarified and their liaison with the board of governors strengthened. On the one hand, delegation of responsibility to permanent or ad hoc committees is essential if complex and time-consuming questions of policy are to receive attention beyond what the board as a whole can give them. On the other hand, such committees should act as arms of the full board and subject to its overall direction and coordination. As in the case of the business conduct committee, the chairman and/or part of the membership of each such committee should be board members, but presumably most members would be from outside the board, by election or appointment. Staff assistance should be made available as needed by each committee, but again under the overall direction of the heads of staff so as to assure efficient integration of separate areas of interest into the total self-regulatory effort. Very likely there would be other aspects of the association's work, not now dealt with through committees, for which this general pattern of member committees with staff assistance would be a useful one.

The association's bylaws provide that nominating committees "shall endeavor, as nearly as practicable, to secure appropriate and fair representation on the board of governors of all classes and types of firms," and there is a similar provision as to nominations for district committees but with the additional requirement that "various sections" within the district be appropriately and fairly represented. At the national level, there has been only limited success in conforming to the bylaw provision, at least partly because the geographic (i.e., district) emphasis in the selection of members of the board of governors, with most districts nominating only a single board member once every 3 years, makes it inherently difficult to provide at the same time for representation of "all classes and types of firms." A possible approach to satisfying the latter requirement might be to provide for a limited number of governors elected at large, so that the various classes and types of business could be taken into account in their nomination. At the district level, there is greater flexibility because the committees all have at least six members, and greater emphasis could be given to this criterion than appears to have been the case. Since membership on the national board normally follows service on a district committee, this emphasis at the district level might itself have some indirect effect in assuring wider representation of various classes and types of firms on the national board.

In addition to these comments on the organizational structure of the NASD, a few specific conclusions of the study should be expressed:

The association has placed comparatively heavy reliance on the examination program in its surveillance of member conduct. This reliance has yielded significant results in uncovering rule violations ascertainable through inspection of books and records but has left much to be desired in other spheres. Association experience with other methods of surveillance, such as the advance filing procedures used for mutual fund sales literature and underwriters' compensation and the questionnaire device employed in instances of suspected free-riding, suggests that still other possibilities for supplementing or augmenting the examination program may exist. In any event, the examination program itself seems to require a large degree of bolstering. The association's frequency goals are relatively modest, but even with limitations on followup procedures apparently caused, at least in part, by the pressure to keep on schedule, these goals have not been met, notably those for branch offices and newly admitted members.

While the conduct of disciplinary proceedings has been generally fair, certain policies and practices have tended to inhibit their effectiveness as a remedial tool. In addition to problems brought about by the increasing delays in disposing of cases, their corrective value appears to have been noticeably impaired (at least until recently) by restrictive policies toward publication of results, while disparity in the penalties assessed against violators may raise questions of fairness in particular instances.

As the 1962 chairman of the board of governors recently told NASD members:

> Obviously, additional staff will mean additional expenses and although our 1963 budget substantially exceeds that of 1962, the industry must be prepared to finance the benefits allowed it under the Maloney Act.

Whether or not the point was in the chairman's mind, implementation of the recommendations of this report would undoubtedly tend in this direction, although presumably capable of being at least partially offset by the raising of entry standards for members (see ch. II) and by better coordination and elimination of duplication among agencies (see pt. J). In any event, there is reason to believe that the financial burden on the general membership of the association need not be materially increased if there is greater resort to some classes of members who may not now bear a fair share of the costs. For example, the fee structure provides for a special charge measured by underwriting activities but not for trading activities. Thus the 67 largest over-the-counter firms, each of which had more than $100 million in over-the-counter sales in 1961 and accounted for 54 percent of all such business in that year, paid only 16 percent of the total assessments collected by the NASD in fiscal 1961; and 27 of these firms, with 16 percent of the sales volume, each paid under $1,000 in assessments and a total of a little more than 1 percent of aggregate member assessments in 1961. In addition, the maximum assessment limits applicable to all firms may have unduly limited the association's revenues from some of the largest firms.

Finally, what must be considered the greatest lack in the NASD's performance as a self-regulatory body is its failure to address itself

to various important problems of the over-the-counter markets. It has made many important advances throughout its history, but some of its major achievements have represented not a taking of initiative to grapple with a problem but rather a defensive response to a pending proposal or imminent action of the Commission. The "markup" and "free-riding" policies of the association are examples of NASD accomplishments in response to impending Government action. In other areas described in this report the NASD either has not acted or has taken what must be considered as inadequate action in dealing with problems that would seem to have called for greater attention.

It is appropriate to repeat here as to the NASD's self-regulatory activities what has already been said in part A of self-regulation generally—that it has basically proven itself in practice despite the shortcomings pointed out in the report. The study's discussion of the latter is not intended to overshadow or disparage the record of accomplishment but to point toward an even stronger future role.

The Special Study concludes and recommends:

1. The NASD's job of self-regulation is a peculiarly difficult one, involving as it does a unique combination of these factors, among others: (a) Its membership is very large and not preselected—it is compelled to open its doors to all qualified persons, and the qualifications have not been particularly selective. (b) Its membership is nationwide and virtually all-embracing, so that differences in practices and concepts resulting from different kinds and sizes of firms and their different locations and varied activities must be encompassed and in some degree reconciled. (c) Its scope of responsibility is very broad—virtually as broad and varied as the securities business—but at the same time it has primary responsibility in the vast but relatively uncharted over-the-counter area. (d) Its emphasis has been on members regulating and disciplining themselves as distinguished from being regulated and disciplined by a hired staff, yet the enormity of the job to be done is difficult to reconcile with the limited demands that can be made on individuals volunteering time away from their main business. (e) Its purpose of promoting voluntary compliance with ethical standards beyond the reach of formal regulation has limited its resort to codification or other "legalistic" techniques that might ease its burden of day-to-day regulation.

2. Despite many accomplishments in its relatively brief history, the NASD has fallen short of its potential as a self-regulatory agency—not only in sometimes failing to reach adequate results in areas that it has undertaken to deal with, but in failing to deal with some areas that would seem to have called for self-regulatory attention. If the association is to fulfill its role as the principal self-regulatory agency for nonexchange members and is not to collapse under the weight of its job in relation to its organizational structure, the structure must be basically modified and strengthened. This would be true even assuming no increase in the breadth or depth of the association's activities; the need may be even greater in light of the substantive conclusions and recom-

mendations in various chapters of this report that would enlarge its role of self-regulation.

3. A prime and urgent need is to realine functions and responsibilities, as between member officials and paid staff and also as among member officials, so that the chairman and board of governors may perform their paramount role of leadership in policy determinations. The recommendations in the following two paragraphs, which stop considerably short of what the major exchanges have done in the direction of diminished reliance on member committees and increased reliance on full-time staffs, must be regarded as minimum organizational changes needed at this time.

4. Without limiting the concept of self-regulation by members themselves, but rather in furtherance of that concept, the NASD's paid staff should be increased in size, stature, and responsibility. The office of executive director should be upgraded to that of president and he should be made a voting member of the board and some or all of its standing committees. With adequate assistance of vice presidents and department heads, he should have responsibility for continuous administration by the entire staff, both in national and district offices, subject to the overall direction and control of the board of governors. To further these objectives, consideration might be given to granting tenure for a limited period of years to a holder of the office, as in the case of some of the stock exchanges. The staff should have a larger role in all enforcement and disciplinary activities, both for the purpose of assuring systematic and consistent attention to surveillance and enforcement of established rules and policies and for the purpose of relieving volunteer members of routine burdens of enforcement and discipline until the stage of actual decision of individual cases. The staff should also be equipped, available, and utilized to conduct studies or otherwise assist elected officials and member committees in formulating policies and programs of self-regulation on a continuing basis.

5. Further to enable the chairman and members of the board of governors to concentrate on larger problems and programs, the National Business Conduct Committee under appropriate liaison with the board of governors should have final power of decision in disciplinary matters, except where the board in its discretion "takes jurisdiction" because of the novelty or importance of particular cases or questions. Apart from disciplinary matters, important topics and programs requiring more concentrated attention than the board itself can give should be the province of permanent or ad hoc member committees under appropriate liaison with the board. An executive committee that can be expected to meet more frequently than the full board of governors should be given increased authority to act on its behalf in the intervals between board meetings. With regard to the foregoing and all other forms of member participation in the affairs of the association, the enlarged and strengthened staff recommended above should be equipped and available to provide guidance, assistance and continuity.

6. The association should give consideration to ways and means of obtaining a better distribution of seats on district committees and the board of governors by size and type of firm. Among the possibilities as to board representation which might be explored would be an amendment to the bylaws permitting election or appointment of a limited number of governors-at-large in instances where the present geographic emphasis results in lack of size or functional representation for a particular class of firms. At the district level, existing bylaw provisions appear to be sufficiently flexible to achieve these objects to a greater degree than is now the case.

7. The NASD's modes of surveillance of members' conduct are quite limited even in relation to the present scope of its self-regulatory concern, and there is considerable diversity in methods and extent of surveillance as among districts. In any event surveillance machinery will need to be strengthened to cope with the wider scope of the association's activities under the substantive recommendations made in other chapters. The basic limitation of staff (see par. 4) should be corrected as promptly as possible, with the national office staff generally directing and coordinating the surveillance activities of district staffs. Automated data processing undoubtedly offers many possibilities for enlarged and more efficient surveillance activities of the entire organization (as well as for other important uses, see ch. VII.E) and for this additional reason should be the subject of prompt and continuing attention of the NASD.

8. Disciplinary procedures, protected by statutory prescriptions and provisions for Commission review, have been generally fair. However, a lack of clear definition and/or adequate publication to the membership of some of the association's broad standards of conduct, coupled with the regional emphasis that has been characteristic of its self-regulatory approach, has resulted in some unevenness and possible inequity in disciplinary results. The principal problem, of considerable seriousness even though not exclusive to the NASD, has been with respect to efficiency and speed in handling disciplinary cases. Among possible procedural improvements, district secretaries, under the general supervision of the national office staff, should have the responsibility of reviewing all inspection reports, and they as well as appropriate members of the national staff should have broader authority to investigate apparent violations disclosed in such reports or in public complaints, including greater freedom to question members and customers directly. They should make recommendations to the district business conduct committees for formal complaint proceedings, and should, as at present, regularly report to the national office regarding all matters investigated. Consideration should be given to eventually delegating to the national office the authority to file formal complaints and to utilizing full-time hearing officers in some or all formal disciplinary proceedings where this would lighten the burden of hearings now imposed on district committees or other members; ultimate decision on the record should be made by the district committees, subject to review, as at present but with the modification suggested in paragraph 5 above.

As a general principle, with such general or specific exceptions as the Commission may approve, disciplinary matters resulting in the imposition of penalties should be publicly reported; informally imposed sanctions such as letters of caution should be periodically reported to the Commission.

9. The NASD historically has operated on a relatively limited budget in relation to its responsibilities, although recently there have been substantial increases. In any event its future role may require further increases, even though, in accordance with other recommendations in the report, the total financial burden of regulation and self-regulation hopefully may be reduced by raising business entry standards and through a better division of labor and coordination of effort among regulatory and self-regulatory agencies. Apart from possibly increased budgetary needs, the association's present fee structure may be inequitable insofar as it takes into account the amount of underwriting business but not the amount of trading activity of its members, and also in having overall ceilings regardless of size of a member's business. The NASD should pursue studies looking to early revision of its fee structure in relation to the business of its members and its own budgetary requirements.

H. Certain Quasi-Self-Regulatory Organizations

In addition to the officially recognized self-reglatory bodies, there exist in the securities business several unofficial organizations, some of which perform, or purport to perform, self-regulatory functions. Some of them antedate statutory recognition of the exchanges as self-regulatory bodies and the formation of the NASD; others were organized more recently.[529]

1. INVESTMENT BANKERS ASSOCIATION

The oldest and perhaps best known of these organizations, and a progenitor of the NASD itself, is the Investment Bankers Association of America (IBA).[530] Essentially, it is an association of underwriters, but its membership includes general broker-dealers, stock exchange specialists that meet certain working capital requirements, sponsors of mutual funds that meet certain asset requirements, and commercial banks that have bond departments engaged in underwriting State and municipal securities. Members are required to be of good reputation, to have been in business for 3 years, and, in the case of broker-dealers, to have adequate minimum net working capital, in no event less than $50,000. As of December 31, 1962, there were some 792 member firms.

According to the constitution of the IBA, it was formed——

> In order * * * better [to] serve those who purchase and those who sell securities, through which the necessary funds are raised for the operation and expansion of business activities and for the carrying on of public functions, * * * and in order [to] * * * aid in these directions through mutual cooperation,

[529] The discussion in this part of the report does not cover all industry groups whose activities in some measure involve securities regulation. Several such organizations are excluded because the impact of their activities on the securities industry is relatively minor or indirect.

[530] The IBA was founded in 1912.

through the maintenance of high standards of service, through self-regulation and through the support of appropriate legislation * * *.

It in fact performs no self-regulatory functions as such, in the sense of promulgating and enforcing specific standards of business conduct, but it has devoted extensive attention and effort to industry-education projects in addition to usual trade-association activities. Among its important study groups are committees on the Canadian economy, Federal taxes, foreign investments, aviation, public utilities, railroads, oil and natural gas, and government, industrial and insurance securities. Its educational efforts, from some of which the entire industry benefits, have included the conduct of an annual Institute of Investment Banking at the Wharton School of the University of Pennsylvania and of regional classes and seminars, participation with other industry groups in a "Joint Committee on Education," the conduct of a continuing research and study effort by a regular paid staff, and the sponsorship or publication of books and pamphlets relating to the investment banking business.

2. ASSOCIATION OF STOCK EXCHANGE FIRMS

The Association of Stock Exchange Firms (ASEF), founded in 1913 and reorganized in 1941, is a trade association which limits its membership to New York Stock Exchange member firms. It has about 600 [531] members and 21 "regional organizations" which provide a forum for the discussion and expression of local views. The ASEF is managed by a small professional staff under the direction of a 38-member board of governors.[532] The ASEF's principal functions are to—

make available to members many technical services enabling them to operate more economically and efficiently; to provide a medium through which ideas, experiences and information may be exchanged by members for their mutual benefit; to keep members advised of new trade practices and legislative developments affecting their interests and to give authoritative voice to industry views when called upon to make them known to the many government and industry regulatory bodies and Federal, State and city legislative councils.[533]

The ASEF neither purports to perform nor performs any regulatory or enforcement functions. It is best known for its activities directed at improving the technical proficiency of its members.[534] The ASEF has six operating divisions: accounting, cashiers, credit, dividend, purchases and sales, and senior order clerks. These divisions with a combined membership of 3,000 limit their membership to "senior employees of member firms." Their function is to conduct educational programs and deal with industry problems of a technical nature. For example, the credit division publishes a comprehensive looseleaf manual containing a complete set of bulletins covering, among other things various problems of cash and margin department work, Federal and NYSE margin and cash account rules, conduct of customers' accounts, puts and calls, commodities, and legal aspects of

[531] As of January 1963, its membership consisted of 518 firms and 78 individuals.
[532] Members of the board of governors are about evenly divided between those having their principal places of business in New York City and those from other parts of the country.
[533] ASEF Annual Directory and Guide, pp. 5–6 (1962–63).
[534] The ASEF also concerns itself with general industry matters. For example, it has recently given attention to the Special Study's legislative program, the administration's tax program, and developments in the European Common Market. Through its foreign business committee, the ASEF has kept abreast of significant changes in the trading of foreign securities.

"sellouts." And the accounting division publishes a standardized chart of accounts to simplify members' accounting practices.

The ASEF also offers its members certain other services and educational materials. It assists members in finding qualified back office personnel and provides them with standardized account and transaction forms. It conducts educational programs on various aspects of office operations and makes available to its members publications on control and protection of cash and securities, Federal wage and hour laws, gifts of securities to minors, internal controls applicable to brokerage firms, NYSE minimum commission rates, preservation and destruction of records, procedures for soliciting proxies where stock is registered in brokers' name and methods of transferring securities. It also offers its members study materials for registered representatives.

3. INVESTMENT COMPANY INSTITUTE; ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.

In the mutual fund field two organizations should be noted, the Investment Company Institute (ICI) and the Association of Mutual Fund Plan Sponsors, Inc. (AMFPS).[535] The Investment Company Institute was organized at about the time of the enactment of the Investment Company Act of 1940 to provide an authoritative industry group with which the Commission might work in administering the new statute. In October 1961, as part of a general reorganization, its name was changed from the National Association of Investment Companies and membership was opened to investment advisers and underwriters of investment companies.[536] The ICI is currently made up of most open-end investment companies registered under the Investment Company Act,[537] as well as Canadian investment companies, investment advisers, and underwriters.[538] It has a small paid staff, which since 1962 has been headed by a full-time paid president.

The stated purposes of the ICI include providing a medium for intraindustry and industry-government conference, consultation, and cooperation; providing facilities for the collection and dissemination of information relating to, and the discussion of problems of, the management-investment-company business; and encouraging adherence to high ethical standards by all elements of that business.

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[535] Particular aspects of the activities of the ICI and the AMFPS as they relate to specific problems are discussed in ch. XI.C.3.c. and ch. XI.B, respectively.

[536] The ICI is principally organized into investment company, investment adviser, and underwriter divisions. The inclusion of investment advisers and underwriters may present problems in that their interests may at times be at variance with each other and with those of the investment company members. Such problems perhaps might be mitigated by the following provision of the memorandum of association which provides for action of the membership to be taken as follows:

"* * * with respect to matters affecting only one division of the institute the divisional committee of that division shall determine the manner in which any action of its members is to be taken and the procedure to be followed; with respect to matters affecting the institute as a whole, the board of governors shall determine the manner in which any action of the members is to be taken and the procedure to be followed."

The memorandum of association requires that 11 of the 21 members of the ICI's board of governors be officers or trustees of investment company members.

[537] The ICI had, as of June 30, 1962, 172 member companies of the 319 mutual funds registered with the Commission as of that date. The assets of the ICI's members amounted to 94 percent of the assets of all registered open-end investment companies as of that date.

[538] The membership of the ICI at one time included closed-end investment companies. Shortly before the reorganization in October 1961 these companies voluntarily withdrew from membership to form their own association, the Association of Closed-End Investment Companies, in the belief that their interests could be served best through a separate organization. The two organizations maintain a close liaison.

The ICI has sought to effect its purpose of adhering to high ethical standards in part by the adoption of a formal set of standards entitled "Guide to Business Standards for Members of the Investment Company Institute." The guide suggests that investment company officials and employees should refrain from private dealings in securities which they know their company has determined to purchase or sell for its portfolio or where they know such action to be under immediate consideration;[539] discourages release of information about portfolio changes that have been or are in process; opposes the purchase of securities by investment companies shortly before ex-dividend dates primarily for the purpose of obtaining the immediate dividend; encourages the conduct of portfolio transactions in a responsible way in pursuance of member companies' stated investment objectives and subject to restrictions relating to reciprocal business; discourages "special deals" to selling group members; and establishes standards relating to the announcement of income and capital gains distributions. There are, however, no sanctions for violation of the guide: the ICI is not organized in such a way as to have real authority over its members and its governing documents do not provide even for the termination of the membership of an offending member.

The Association of Mutual Fund Plan Sponsors, Inc., restricts its membership to firms sponsoring contractual plans. Membership is open to both firms and individuals, but only firms have joined. In April 1963, 22 of the 50 principal mutual fund plan sponsors in the United States were members, accounting for approximately 66 percent of the aggregate value of contractual plans sold as of December 31, 1962.

The stated purposes of the AMFPS are those usual to a trade association and include settling and adjusting differences among its members. Although the stated purposes do not include self-regulation or the formulation and enforcement of standards of business ethics, the AMFPS has, in fact, adopted a code covering general business, competitive, investment management, and dealer practices. Perhaps its most notable provision is one that requires each member to afford each new purchaser of a contractual plan a 30-day right to cancel his commitment and obtain a full refund of his initial payment, without specifying a reason. Another provision, however, expressly permits its members to offer special selling inducements to their dealers and salesmen, in contrast to the position espoused by the NASD and the provision prohibiting such special deals in the ICI Guide. Members violating the code are theoretically subject to various penalties ranging from reprimands, through fines up to $1,000, to suspension or expulsion from membership. No surveillance or enforcement machinery has been created, no formal disciplinary proceedings have ever been undertaken, and no penalties have ever been imposed.

4. INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.

One rather specialized organization is active in the investment advisory field. The Investment Counsel Association of America, Inc. (ICAA), is made up of a group of firms that have voluntarily restricted themselves to what they consider to be the purest and highest

[539] For further discussion of this subject, see ch. XI.D.

type of investment advisory service, namely "primarily * * * giving continuous advice as to the investment of funds of its clients on the basis of the individual needs of each client * * *" exclusively on a fee basis. As of July 1963, the ICAA had 52 members, including all but a very few of the firms that the association would deem eligible for membership.

The stated purposes of the ICAA are:

> To promote integrity, public responsibility, and competence in the profession of investment counsel.
>
> To promote the study of investment analysis and management and to collect information relating to all aspects of the profession of investment counsel for the use of the members of the corporation and others.
>
> To consult and cooperate with federal and state governmental agencies and all other interested persons or groups for the development, formulation, and enactment of legislation relating to investment counsel and of rules and regulations thereunder.

The ICAA has adopted a "Statement of Functions and Principles," which limits the functions of investment counselors to rendering advice exclusively on a fee basis; and prohibits any activity that would jeopardize the ability to render unbiased advice; encourages competence and responsibility in the performance of the functions of investment counselors; and exhorts members to observe "professional" standards in the solicitation of new clients and in the confidential treatment of clients' affairs.

The ICAA's bylaws give its board of governors power to discipline a member by suspension or expulsion for violation of the Investment Advisors Act of 1940 or the association's bylaws, or for any "just cause," which presumably would include violations of the "Statement of Functions and Principles." No detailed code of standards has been adopted or formulated, however, and the association has made no real effort to discipline its members. The ICAA does not, in fact, presently conceive of itself as a self-regulatory body, but rather concentrates on attempting to achieve public recognition of the specialized and assertedly professional nature of the services its members provide and of the distinction between these services and the various investment advisory services offered by broker-dealers and others who are compensated for other than strictly advisory activities.[540]

Recently the ICAA has also undertaken, experimentally, an educational-qualification effort that envisages the awarding to persons qualified by reason of experience and formal education of the designation "qualified associate" of the association.

5. ASSOCIATION OF REAL ESTATE SYNDICATORS

In the relatively new field of real estate securities,[541] an organization known as the Association of Real Estate Syndicators (ARES) has become active. Its scope is theoretically nationwide, but its

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[540] Over the years a principal activity of the association has been its efforts to achieve formal recognition of the concept of investment counsel as distinguished from the general concept of investment advice, and in those instances where formal recognition has been obtained to protect the designation against diminution in its meaning and effect. The efforts of the ICAA were largely responsible for sec. 208(c) of the Investment Advisers Act of 1940 which provides:

"It shall be unlawful for any person registered under sec. 203 of this title to represent that he is an investment counsel or to use the name 'investment counsel' as descriptive of his business unless—

"(1) his or its principal business consists of acting as investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services."

[541] See ch. IV.E.

membership is apparently largely restricted to the New York City area, where real estate syndications and distributions of real estate securities have been concentrated. Members include syndicators, persons associated in a professional capacity with them, "affiliates," i.e., persons such as brokers or salesmen having business relationships with syndicators, and "financial affiliates," i.e., persons connected with financial institutions serving the real estate syndication business. In May 1962 the ARES had 64 New York State members.

The stated purposes of the ARES include the establishment, promulgation, and maintenance of high standards of ethics, business practice, and fair dealing. The association has adopted a code of ethics, the main thrust of which appears to be to provide investors in real estate securities full and truthful disclosure of the material facts relevant to their investments and, in a somewhat general way, to control selling practices. Violations of the code are "punishable" by publicity, reprimand, or suspension or expulsion from membership.

Formerly, the ARES maintained elaborate machinery for the review and clearance of prospectuses by a "brochure panel." A brochure not approved was not allowed to be used, but a member dissatisfied with the panel's withholding of approval could appeal to a special body composed of board members and members of the panel. When New York State adopted its real estate syndication law in 1960 [542] and the State attorney general began to perform his functions under it, the activities of the panel were discontinued.

6. PUT AND CALL BROKERS AND DEALERS ASSOCIATION

The most highly organized of all the unofficial self-regulatory organizations is the Put and Call Brokers and Dealers Association (PCBDA). It was formed in 1934 to represent the interests of put and call broker-dealers during the congressional hearings that preceded enactment of the Exchange Act and today includes among its membership virtually all persons engaged in that highly specialized occupation. In many respects the association is as highly institutionalized as an exchange and the business in which its members engage is as strictly controlled as are dealings in listed securities. The purposes of the association are:

> * * * to foster the maintenance of high standards of integrity and honor in all business dealings by its members; to prevent any trade practices which may be or may tend to be unfair or inequitable; to establish trade practices which are conducive to harmonious relations among its members and to efficiency in the conduct of their business, and thus to enable them to better serve the persons with whom they deal, or on whose behalf they act; and to provide for the settlement by arbitration of all differences and disputes arising between members, and otherwise to promote their welfare.

The organization and functioning of the PCBDA were described as follows in a report on put and call options issued by the Commission's Division of Trading and Exchanges in August 1961: [543]

MEMBERSHIP REQUIREMENTS

Any person may become a member of the association if approved by the board of directors. The board, with the assistance of the committee on admissions, considers the character and reputation of the applicant and also the

[542] New York General Business Law, secs. 352–e to 352–j.
[543] The Special Study has made no independent survey of the activities of the PCBDA and has limited its analysis to the findings of the August 1961 report.

applicant's knowledge of the put and call business. An affirmative vote of two-thirds of the board is required for acceptance as a member.

* * * In February 1959, the [initiation] fee was raised to $10,000 and in June 1961 it was increased to $25,000. Members also pay annual dues of $100.

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Members may transfer their memberships to other persons with the approval of the board of directors. The price paid is negotiated by the two parties. Prior to June 1961, the association received nothing except perhaps a $25 or $50 transfer fee for any expenses it may have incurred. Since then, however, they have imposed a nonrefundable fee of $250 to accompany each application for transfer and an additional $1,000 fee to be paid to the association if the transfer is approved.

Despite the large increase in put and call volume, the number of members has been almost constant for the past several years and is considerably less than in the early years of the association. In 1940, there were approximately 45 members but in early 1961, there were only 28 members. The reason for this may be the complicated nature of the business and the size of the initiation fee. New members have been admitted for the most part only when other members resigned. There have been few new memberships issued. The board, however, has been urging inactive members to transfer their memberships. During 1960, three such transfers were effected.

BOARD OF DIRECTORS

The association is governed by a board of six directors including the president. Directors serve for 3-year periods and two new directors are elected each year. * * *

The board of directors meets regularly each month. The board has "full power and authority to administer the business and affairs of the association, to regulate the dealings and business conduct of the members, and to promote the objects and purposes of the association, with full authority to make, promulgate and enforce rules, orders and decisions to that end."

* * * The board may try charges against members and impose penalties such as fines, suspensions, or expulsions where it determines that a member has violated the association's constitution, bylaws, or rules or is "guilty of business conduct inconsistent with equitable, fair and honorable commercial dealings."

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OFFICERS OF THE ASSOCIATION

* * * The president is the chief executive officer and sees that all orders and resolutions of the board of directors are carried out.

All officers are presently serving without compensation. However, the board feels that, with the growth of the put and call business and the corresponding increase in the association's activities, there is a need for a full-time paid president.

STANDING COMMITTEES AND OTHER COMMITTEES

* * * At present there are four standing committees although the board may appoint other standing committees, as it deems advisable.

1. The Committee on Business Conduct consists of five members. They consider matters relating to the business conduct of members and their firms in dealing with each other and with their customers. They make and enforce rules and regulations for convenience and fairness in transacting the put and call business. They investigate transactions in options to insure that the association's constitution, bylaws, and rules are being observed. They may inspect the books and records of any member. If they determine that a member has engaged in unethical business practices, they make a report of the matter to the board of directors including recommendations for appropriate action.

2. The Committee on Admissions consists of three members. It is the duty of this committee to consider applications for new memberships and for reinstatement of suspended or expelled members and to make recommendations to the board.

3. The Committee on Publications, comprised of three members, has the power and duty to make and enforce rules and policies prescribed by the board of directors for the regulation of all business advertisements and all other literature of an advertising nature. The committee must approve all pamphlets, circulars,

advertisements, quotation sheets, letters, and other advertising literature at least 48 hours prior to their publication or distribution by the member. All such literature and all contracts and bills, as well, must bear the legend "Member of Put and Call Brokers and Dealers Association" after the name of the member. This committee was formed in 1944 when the Wall Street Journal agreed to a plan of the Put and Call Brokers and Dealers Association to publish "official quotations" on options a few times a week. * * * With the more extensive advertising of special options by individual dealers in recent years, The Journal decided that the "official quotations" did not serve any purpose and their publication was discontinued.

4. The Committee on Arbitration and Constitution and Bylaws has five members. They have the power to arbitrate all disputes and claims arising between members of the association and also between members of the association and nonmembers. * * *

BYLAWS GOVERNING MEMBERS' CONDUCT

In 1935, the staff of the Commission prepared a report on security options and recommended that the Commission adopt certain rules for the regulation of trading in puts and calls. Except for the requirement that all put and call broker-dealers register with the Commission, these rules were not put into effect. Instead, the association itself incorporated many of the recommendations in its own bylaws. The attitude of the association has always been that it will police its members and it has been most willing to adopt recommendations made from time to time by the Commission's staff. Thus, many of the association's provisions regulating members' conduct and standardizing business practices in option trading are the result of joint conferences between the association and the Commission.

One of the recommendations of the 1935 report which was adopted by the association is the requirement that members file reports of their transactions in options with the association. Prior to these reports, which were started in 1936, no one knew how large the option market was; its size could only be estimated. Over the years, the statistics collected in this program have given an accurate picture of the extent and growth of the option market and of the types of options traded.

Members are also required to keep records of all purchases and sales of option contracts including the time of execution of the purchase or sale. These records must be retained for a period of 6 months after the date of exercising the option or of its expiration.

* * * * * * *

According to the association's constitution and bylaws, nonmembers are not allowed to share office space or be permitted the use of facilities of members for any transaction pertaining to the sale or purchase of option contracts. Active members of the association may not be employed by stock exchange firms or over-the-counter houses. These provisions were designed to make it more difficult to manipulate the market. Persons who held options would not be in a position to induce others to purchase or sell the securities in the option.

Members of the association may not share commissions or profits with any nonmembers except those who are registered with the Securities and Exchange Commission. This was a recommendation of the 1935 report. The association limits the amount of commissions which may be paid to the nonmember to a maximum of $6.25 for each 30-day option of 100 shares.

STANDARDIZATION OF OPTION CONTRACTS

One of the important achievements of the association is the adoption of a standard form of option contract and the establishment of uniform practices in option dealing. Not only has this done away with much confusion, but it has afforded a certain amount of protection to the uninformed option buyers.

The constitution and bylaws of the association state that no member shall make any sale or transfer of a new option contract other than on the official printed contract form. These forms may be obtained only from the association and are issued only to members of the association. All options must be endorsed by member firms of the NYSE or "such other recognized exchange as the board of directors shall, from time to time, authorize by resolution." No other exchange members have ever been authorized. The Commission report of 1935 recommended this endorsement policy but included as endorsers trust companies,

insurance companies, or other types of approved financial institutions, as well as members of stock exchanges.

The association prohibits options of less than 21 days. It requires that 30-day options sold at "points away" must be sold at a fixed premium of $137.50 per 100-share put or call.[544]

Over the years the Commission and the PCBDA have had an informal working arrangement. The association has supplied statistical information on puts and calls to the Commission and specific recommendations made by the Commission's staff have, on occasion, been adopted by the association, including provisions bearing on members' conduct and business practices. Although the PCBDA has no official standing, the association has assumed as firm control over its members and the put and call market as certain official self-regulatory bodies have over their members and members' activities.

7. NATIONAL ASSOCIATION OF INVESTORS' BROKERS; NATIONAL SECURITY TRADERS ASSOCIATION, INC.

Finally, two organizations, the membership of which is based on functional specialization, should be mentioned: the National Association of Investors' Brokers (NAIB) and the National Security Traders Association, Inc. (NSTA). The NAIB has no individual members and only two organizational members, through which it performs all its activities: the Association of Customers' Brokers (ACB), a New York organization; and the Stock Brokers' Associates of Chicago (SBAC). Membership in both of these organizations is restricted to fully qualified, nonpartner registered representatives of stock exchange firms. In New York a member must be a registered representative of a New York Stock Exchange or American Stock Exchange firm; in Chicago, of a New York Stock Exchange or Midwest Stock Exchange firm. At the end of 1961 the ACB had 1,122 members; the SBAC had more than 290 in May 1962.

The ACB has adopted a formal code of ethics and business conduct. The latter contains the following statement of principles:

1. The client's interest shall always be the first consideration of a member of our association.
2. Opinions or advice given by a member, shall be supported by adequate knowledge and information. In making a suggestion a member shall present to a client as many as possible of the relevant facts whether they be favorable or unfavorable. In cases where a member deems it beneficial to a client to transmit unverified information he shall disclose the source and the fact that accuracy of his statement is unverified.
3. Willful and knowing dissemination by any member of false and misleading information, aside from the legal consequences, shall be considered unethical. The giving of incorrect quotations or reports on the condition of the market comes within the same category.
4. Encouraging financial transactions not commensurate with a client's resources, or suggesting highly speculative ventures without explaining the extent and nature of the risk involved, shall be considered unethical.
5. Information concerning a client's transactions and his account shall be considered confidential, and shall not be disclosed except with the client's permission or by order of the proper authority.
6. Methods of soliciting business used by our members shall be dignified and in keeping with the ideals of our association.

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[544] Options typically are exercisable at the market price of the underlying security at the time the option is purchased. Thirty-day options are an exception since they generally are exercisable at a number of points above the market if a call or a number of points below the market if a put.

7. The services or policies of a competitor shall not be criticised by a member of this association unless his opinion is requested, in which event his opinion shall be impartial.

8. Laws, rules, and regulations of the Federal and State governments, of the New York Stock Exchange and other exchanges, where a member may be registered and of various regulatory bodies shall be adhered to by every member. A member shall consider it a duty to keep informed of new legislation governing his activities.

9. The interests of the firm with which the individual member is associated shall be safeguarded at all times. A member shall exercise care in the introduction of accounts, shall insist on his clients' observance of the letter and spirit of any laws and regulations governing the clients' transactions, and shall carry out his firm's requirements affecting his accounts. In those cases where a client makes unjustifiable demands, a member shall not accede to them to incur good will.

10. The reputation of our business shall always be kept in mind and each member shall conduct himself with a view to commanding the respect and confidence of the public. A member shall be ever mindful of the good name of this association.

The SBAC apparently has adopted no formal code of ethics or standards of business conduct, but has adopted, as part of its constitution, a statement of purposes, which include:

> To preserve the high standards of our profession.
>
> To promote mutual understanding of the problems involved in security transactions between the public and the financial community.
>
> To aid and further the high aims and business integrity of the National Exchanges of which our firms are members.[545]

Since neither the NAIB nor its two affiliates have official standing or purport to engage in any surveillance or enforcement, their actual regulatory significance would appear to be minimal despite the worthiness of their expressed principles and purposes.

The National Security Traders Association, Inc. (NSTA), was founded in 1934 and for many years it functioned primarily as a social organization designed to permit over-the-counter traders to become personally acquainted with other traders with whom they dealt over the telephone. More recently it has interested itself in educational matters and in publicizing the over-the-counter markets. Individuals occupied as traders for registered broker-dealers "in an executive capacity" for a term of at least 1 year are eligible for membership. At the end of 1961 there were approximately 5,000 members.

In 1961 the NSTA, in conjunction with 300 broker-dealer firms, initiated the "OTC Educational Program." While this is purportedly designed to educate the public concerning the over-the-counter markets, a review of the progress of the first year of the program indicates an emphasis upon generating investor interest and activity in over-the-counter securities. The NSTA also participates with other industry organizations in training programs and proposes to issue a trading handbook in 1963. The NSTA has also recently indicated an interest in acting as a representative of individual traders in matters of concern to the securities industry. Although its constitution and bylaws state that one of the objects of the NSTA is to establish and maintain high standards of ethical conduct and provide that a member may be expelled for conduct "inconsistent with just and equitable principles of trade," the NSTA has not assumed any self-regulatory functions.

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[545] The constitution of the ACB includes similar organizational purposes.

8. SUMMARY AND CONCLUSIONS

A number of associations of persons and firms in the securities business perform, or purport to perform, self-regulatory functions in addition to trade-association activities. The measure of control which these organizations exercise over their members varies considerably. Some, such as the Investment Company Institute and the Association of Mutual Fund Plan Sponsors, Inc., have promulgated codes of business ethics, although they have not established any surveillance or enforcement machinery.

Other groups—the Investment Bankers Association, Association of Stock Exchange Firms, and the Investment Counsel Association of America, Inc.—although having the aim of raising industry standards, concentrate their efforts on projects of an educational nature or related to qualifications of their members and their employees. Still others, such as the National Security Traders Association, Inc., have somewhat heterogeneous functions combining social with educational and promotional activities and making little or no effort to engage in self-regulation. There is, however, one body, the Put and Call Brokers and Dealers Association, which, although without official standing, exercises controls over its members and their market activities that appear to be as extensive as those exercised by many exchanges.

The survey of the limited number of organizations just given is sufficient to indicate that, even where they have significant regulatory purposes, they largely lack programs for making them effective and, under the doctrine of *Silver* v. *New York Stock Exchange*,[546] might run afoul of antitrust policy if they attempted to enforce certain types of regulation without statutory sanction or official review of their action. In any event, they cannot be considered as providing a satisfactory source of self-regulation or substitute for regulation in areas where regulation is deemed necessary in the public interest or for the protection of investors.

Ideally, official self-regulation should be extended to include all elements of the securities business that feasibly can be included; recommendations have been made accordingly in chapters II, III, IV, and XI in relation to mutual fund selling organizations, distributors of and dealers in real estate securities, investment advisers, and others not now subsumed under an existing self-regulatory organization.[547]

I. Self-Regulation and the Commission

The principal self-regulatory organizations surveyed in previous parts of this chapter, along with the Commission and the States, compositely supply the regulatory protection of investors and the public interest, which in the broadest sense it has been the task of the Special Study to survey and assess. The workings and effectiveness of the regulatory pattern are significantly affected not only by the functioning of each separate agency but by the interrelationships among them. In particular, the role of the Commission in relation to each of the

[546] 373 U.S. 341 (1963). The *Silver* case is discussed in pt. I, below.

[547] The Commission's 1963 legislative program, designed to carry out these recommendations, includes a proposal to make membership in a registered securities association mandatory for broker-dealers doing an over-the-counter securities business. See S. 1642 and H.R. 6789 (also numbered 6793), 88th Cong., 1st sess. (1963).

other agencies, by statute and in practice, becomes crucially important in an appraisal of the adequacy of existing regulatory protections.

This part of the chapter first summarizes some of the considerations of theory and policy underlying the concept of self-regulation—both its conceived purposes and uses and its inherent or practical limitations—and then analyzes the role of the Commission in relation to the broad concept. After outlining the respective statutory patterns applicable to stock exchanges and national securities associations, it then reviews briefly the actual functioning of the regulatory patterns in relation to the exchanges, particularly the New York Stock Exchange, and the National Association of Securities Dealers, in each case treating separately the process of rulemaking and the process of enforcement. As was previously pointed out as to the entire chapter, various of the other chapters dealing with substantive topics, especially II, III, IV, VI, VII, and VIII, contain separate discussions of the role of the Commission in direct regulation and in relation to the self-regulatory agencies.

1. THE THEORY AND POLICY OF SELF-REGULATION—ITS PURPOSES, USES, AND LIMITATIONS

a. Purposes and uses

Mr. Justice Stewart, speaking for a minority of the Supreme Court in *Silver* v. *New York Stock Exchange*,[548] but in this respect seemingly expressing what would also be the majority's formulation, has very succinctly stated the essence of self-regulation in the securities field:

> The purpose of the self-regulation provisions of the Securities Exchange Act was to delegate governmental power to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry.[549]

As indicated at the outset of this chapter, practicality or expediency was the primary ground for resorting to self-regulation as a control technique in 1934: "the sheer ineffectiveness of attempting to assure [regulation] directly through Government on a wide scale."[550] But other advantages were recognized even then, at a time when the self-regulatory concept was applied only to stock exchanges, and additional merits have since been advanced or become evident in connection with both stock exchanges and the sole national securities association.

For one thing, members of the affected business can bring to bear on the problems of regulation a degre of expertness, and in many circumstances expedition, not to be expected of a necessarily more remote governmental agency. It is a truism that the securities business is

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[548] 373 U.S. 341 (1963).

[549] 373 U.S. at 371. Essentially the same thoughts were expressed by Mr. Justice Goldberg for the majority in passages pointing out that Congress was moved to enact the Exchange Act by the growth in power and impact of stock exchanges and "their inability and unwillingness to curb abuses which had increasingly grave implications because of this growth"; quoting Mr. Justice (then Commission Chairman) Douglas' expression of "letting the exchanges take the leadership [through self-regulation] with Government playing a residual role": quoting a Senate committee report stressing that initiative and responsibility for regulation of their ordinary affairs was to remain with the exchanges themselves and only where they failed adequately to provide protection for investors was the Commission "authorized to step in and compel them to do so"; and then referring to, in his own words, "the federally mandated duty of self-policing by exchanges" and "the statutorily imposed duty of self-regulation."

[550] Hearing on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d sess., p. 514 (1934).