REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION

PART 5

CONSISTING OF

LETTERS OF TRANSMITTAL FROM THE CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, LETTERS OF TRANSMITTAL FROM THE SPECIAL STUDY OF SECURITIES MARKETS, AND THE SUMMARIES, CONCLUSIONS, AND RECOMMENDATIONS OF PARTS 1, 2, 3 AND 4 OF THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, RELATING TO THE ADEQUACY OF INVESTOR PROTECTION IN THE SECURITIES MARKETS, PURSUANT TO SECTION 19(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 87-196)

SEPTEMBER 17, 1963.—Referred to the Committee on Interstate and Foreign Commerce and ordered to be printed

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REPORT OF
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OF THE
SECURITIES AND EXCHANGE COMMISSION

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SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., September 17, 1963.

The PRESIDENT OF THE SENATE,
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIR: On August 8, 1963, the Commission transmitted to the Congress the final chapters of the Report of the Special Study of Securities Markets. This report was authorized by section 19(d) of the Securities Exchange Act of 1934, Public Law 87–196. Today I have the honor to transmit in one volume, designated as part 5 of the report, all of the summaries, conclusions, and recommendations of the Report of the Special Study, as well as the letters of the Commission and of the Special Study of Securities Markets which transmitted the various installments of the report.

This material, when printed as a single volume, is expected to serve an important and necessary purpose. The scope and the size of the report create a need to present the findings of the Special Study in a concise form. As a single volume, this report should be useful to many persons, both in Government and private industry, who may not have an opportunity to read the report in its entirety.

By direction of the Commission:

WILLIAM L. CARY, *Chairman.*

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PREFACE

This volume (H. Doc. 95, pt. 5) contains the letters of transmittal from the Chairman of the Securities and Exchange Commission and the Special Study of Securities Markets and summaries, conclusions, and recommendations of the various chapters and parts of chapters, in the same form as they appear in the Report of the Special Study of Securities Markets (Part 1, Chapters I, II, III, and IV; Part 2, Chapters, V, VI, VII, and VIII; Part 3, Chapter IX; and Part 4, Chapters X, XI, XII, and XIII). This volume also contains brief descriptions of the contents of those chapters and parts of chapters which contain no summaries, conclusions, or recommendations.

LETTERS OF TRANSMITTAL FROM THE CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 3, 1963.

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIR: I have the honor to transmit the first segment of the Report of the Special Study of Securities Markets. The report is submitted pursuant to section 19(d) of the Securities Exchange Act of 1934 (Public Law 87–196), which directs the Commission to make a broad study of the adequacy of investor protection in the securities markets.

I

At the outset we emphasize that, although many specific recommendations for improvements in rules and practices are made in the Report of the Special Study, the report demonstrates that neither the fundamental structure of the securities markets nor of the regulatory pattern of the securities acts requires dramatic reconstruction. The report should not impair public confidence in the securities markets, but should strengthen it as suggestions for raising standards are put into practice. Serious shortcomings are apparent and the report, of course, has concentrated on their examination and analysis. Yet it is not a picture of pervasive fraudulent activity and in this respect contrasts markedly with the hearings and findings of the early thirties preceding the enactment of the Federal securities laws. The study confirms the strength of those laws and the heightened sense of obligation of the financial community.

At the same time the report makes very clear that important problems do exist, grave abuses do occur, and additional controls and improvements are much needed. The tremendous growth in the securities markets over the past 25 years, and most particularly the increased public participation, imposed strains on the regulatory system and revealed structural weaknesses. Neither the securities acts, the Commission, nor the industry itself fully anticipated the problems arising from the entry of unqualified persons, the spectacular development of the over-the-counter market, the vast number of companies going public for the first time, or a variety of other striking changes. Some of these problems resulted from inadequacies in established enforcement machinery, both Government and industry. Others reflect patterns of conduct now tolerated, but which, upon exposure and analysis, appear incompatible with the public interest. Testimony to this effect has been given by many responsible members of the financial community, in their comments and most vividly in their adoption of

higher standards of conduct without compulsion of law. It is these voluntary standards which regulation should reflect and make generally applicable.

The functions of this report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence. Raising capital from the general public is a marked feature of the American economic system. In this country there are now approximately 17 million shareholders. As the study attests, this phenomenon has been advanced and protected by the securities acts, a proven legislative achievement. Yet no regulation can be static in a dynamic society; unanticipated changes in the markets and the broader public participation should be accompanied by corresponding investor protection. The importance of the capital markets to our national economic progress does not permit anything less than the most fair and efficient operations. Government and industry regulation and the efforts of the financial community must continue to be directed against practices which undermine the integrity of the securities markets and which can only be harmful to the economic growth of this country and to the investors who furnish the funds for that growth.

While the report focuses upon shortcomings in the industry and in the self-regulatory authorities, in certain respects it is an express or implied criticism of the Commission as an institution. The Commission has not fully exercised its powers, nor coped effectively with all of the problems confronting it. There are undoubtedly several reasons for this. Important among these is the expansion of the securities markets, which renders exceedingly difficult the task of identifying and responding to a myriad of new problems while preoccupied with a heavy flow of administrative tasks. Furthermore, at times the Commission has been hampered by a lack of personnel or has concentrated its efforts on particular areas. Finally, in certain instances, statutory power has been lacking. But our job, like industry's, is not to rationalize inactivity but to initiate improvements. The Report of the Special Study will be a catalyst in this process.

As a final prefatory comment, we should like to emphasize that this report is not a commentary on the level of securities prices, nor upon the investment merits of any particular company mentioned. These types of economic analyses have traditionally been outside the scope of the Commission's responsibilities.

II

The complete Report of the Special Study of Securities Markets will be the most comprehensive of its kind in over 25 years. The examination of the securities markets and the writing of the report have been done by a separate group established in the Commission and designated the Special Study of Securities Markets, under the supervision of Milton H. Cohen, Director. The Special Study was given freedom to analyze and point out problems as they appeared to it; in this respect, the judgments, analyses, and recommendations in the report are those of the Special Study and not the Commission. However, the Commission has worked very closely with the study throughout and has gone over every section of the report. We believe that

the report is a thoroughly responsible document. We do not embrace every recommendation as our own, but we do accept them as a sound point of departure for proposals to the Congress, for rulemaking by the Commission and by the self-regulatory agencies, and for discussions with the industry. Like the study, we at the same time recognize the complexities and subtleties of the problems presented.

III

Transmitted here are chapters I through IV, and chapter IX. The remainder of the report, while nearing completion, is not available at this time essentially because of the scope of the undertaking. The Congress repeatedly made clear that the report should be broad and thorough. The study, with the support of the Commission and its operating divisions, has made every effort to carry out this mandate. However, the breadth of the obligation was not evident at the outset and a proper fulfillment necessitates some delay.

The chapters submitted deal with important and basic areas and practices in the securities markets. In many respects they disclose problems calling for vigorous and prompt responses by the Commission and the industry. The Commission will very shortly recommend to the Congress certain legislative proposals (to be discussed below) where the present statutory scheme appears inadequate. An important part of these reflects our continuing belief in self-regulation as an ingredient in protection of the investor. Certain deficiencies can be treated through rulemaking by either the Commission or the self-regulatory agencies. Still others can be resolved only by a more uniform and voluntary adoption of improved procedures by the members of the industry.

A

The report begins where regulation must begin—the point of entry into the business. It is self-evident that the standards of conduct of the securities industry are vitally dependent on the integrity and competency of its personnel. Obviously no system can be devised which eliminates all potential wrongdoers. But the Report of the Special Study concludes that the minimal controls furnished by existing regulations are inadequate. Notable ease of entry is apparent under both Federal law and the rules of the National Association of Securities Dealers, Inc., the self-regulatory agency for the over-the-counter market. With the exception of the major exchanges, significant standards of character, competence, and minimum capital have not been generally imposed. Nor has attention been sufficiently directed to the unique problems of supervisors, such as branch managers, and research analysts. Furthermore, certain sectors of the industry, including most importantly certain distributors of mutual fund and real estate securities and also investment advisers, are not subject to the discipline of self-regulation. In addition, the present legislative scheme, in revolving around the firm as the regulated unit, provides an artificial and unsatisfactory means of focusing on the individual in the many instances where he is the apropriate object of disciplinary action. Finally, useful and needed intermediate sanctions, short of revoking the registration of a broker-dealer, are not available to the Commission.

We shall, therefore, recommend to the Congress legislative proposals in the following direction:

1. Authorizing standards of character, competence and financial responsibility as conditions for entry into the business, to be established and administered by the national securities associations, notably the NASD, which will complement similar regulation by the exchanges of their members;
2. Requiring all firms and individuals to be subject to the authority of one of the self-regulatory agencies;
3. Granting the Commission direct disciplinary controls over individuals and perfecting NASD controls in this area; and
4. Providing the Commission with intermediate sanctions over firms and individuals.

B

A basic factor underlying the enactment of the Federal securities acts was recognition of the intricate nature and high liquidity of securities and of the corresponding duties necessarily assumed by those who deal in them. The heightened public participation in the securities markets severely tested the adequacy of controls, external and self-imposed, particularly in the area of selling practices and investment advice. The examples of sales techniques cited by the study show a striking spectrum: from the illegal operations of boiler rooms to the disciplined patterns of the responsible, reflecting elaborate supervisory procedures and voluntary codes of conduct. Even in the latter, which represent high standards of achievement, serious lapses have occurred. Yet it is their best formulae which, if universally followed, would result in increased investor protection. Certain excesses also appear to have developed in the investment advisory materials of both broker-dealers and investment advisers, as evidenced by fanciful recommendations based on little more than mere rumor. Here again uniform application of the best industry practices would seem to be in order. In this area, legislation is not presently recommended. Powers exist in the self-regulatory institutions and the Commission to advance selling and investment advisory practices.

C

The mechanism, practices and rules for distributions in the securities markets are examined in the report with particular emphasis on the so-called "hot issue" phenomenon that accompanied the active and rising markets of the late 1950's and the early 1960's and involved primarily companies going to the public for the first time. A record flow of these new issues was another critical trial for both the regulatory pattern and industry practices; the findings of the report do not invalidate the general thrust of this pattern or those practices. At the same time particular weaknesses have developed; their elimination should strengthen the distribution mechanism without impairing access to the capital markets. Most of these can be remedied by rules of the Commission and the NASD, with one important exception.

At present a prospectus containing business and financial information about a company must be delivered to the purchasers of the company's stock during a period of 40 days after a registered public offering of that stock. The findings of the Report of the Special Study demonstrate that, particularly in the case of new issues, dramatic price

movements may result from uninformed investor action and that maximum exposure of financial and public information is crucial to securing knowledgeable evaluation of these securities. The Commission will, therefore, recommend to the Congress that, in the case of new issues, the 40-day period be extended to 90 days or such shorter period as the Commission may prescribe by rule or order.

D

Much of the material submitted evidences the fundamental importance of adequate disclosure by issuers as a most vital means of investor protection. The report points out the broad range of problems and abuses in the securities markets, including improper selling practices, misleading public relations, irresponsible investment advice, and erratic "after markets" for new issues, which can be greatly mitigated by the more complete availability and dissemination of financial information. The report further demonstrates, as have prior studies, that the longstanding contrast in the disclosure-oriented protections afforded investors owning securities listed on national exchanges and investors owning securities traded in the over-the-counter market is not warranted. Issuers of over-the-counter securities, unlike their listed counterparts, are under no obligation to comply with the Commission's proxy rules or, except in certain cases, to furnish annual and periodic financial reports. Another void in investor protection in the over-the-counter market relates to insider trading. An insider of a listed company must report his transactions in the company's stock; his short-swing trading profits in the stock are recoverable by the company; and he is prohibited from selling the stock short. The policies expressed in these sections should also be applicable in the over-the-counter market. The so-called sponsorship problem, where an underwriter makes an after-market in a stock he has underwritten and at the same time is represented on the board of directors of the issuing company, has been carefully analyzed by the study. Its findings indicate that the application of the insider trading provisions will not disrupt trading markets in over-the-counter securities, except perhaps in very limited instances which could be handled through exemptions on a case-by-case basis.

Accordingly, the Commission will recommend extension of those sections of the Securities Exchange Act of 1934 which provide for the filing of annual and periodic reports, compliance with the proxy rules, and protections against insider trading to certain companies whose securities are traded in the over-the-counter market. A phased program of coverage would gradually include all those companies with 300 or more stockholders. In the case of bank stocks, which appear to account for about 20 percent of the issues of the over-the-counter market, if Congress so desires, disclosure requirements could be administered by the appropriate Federal bank regulatory authorities in order to integrate these controls with the existing patterns of bank regulation.

E

An analysis of the over-the-counter market will be submitted in our complete report. At this time, however, we wish to inform the Congress that we shall propose a legislative recommendation essentially directed to the wholesale quotations systems of that market.

At present the National Quotation Bureau dominates the business of over-the-counter wholesale quotations. The Bureau, a private corporation, is not regulated by any agency, Federal, State or self-regulatory. Despite the efforts of the Bureau, which has operated with a conscientious regard for the responsibility which its function and dominant position entail, this crucial segment of the over-the-counter market has had inadequate controls; numerous abuses involving quotations have been perpetrated by broker-dealers. Moreover, developments in electronic data processsing have foreshadowed the emergence of new and perhaps revolutionary quotation systems. In view of the vital significance which these systems can have to the functioning of the over-the-counter market, they should not be allowed to emerge without due regard to the welfare of the market and to the public interest.

Accordingly, the Commission will recommend to the Congress that operators of quotations systems, like the National Quotation Bureau, be required to register with the Commission and adopt and enforce rules of fair practice in the use of their systems, just as is presently the case with the self-regulatory agencies.

F

We have described a substantial part of the legislative measures which we shall recommend to the Congress this year. A few others will subsequently be proposed; a very important one of these might concern certain aspects of security credit regulation—which would be submitted only after full coordination with the Federal Reserve Board. Not all of the study's legislative recommendations in the chapters transmitted have been adopted by the Commission; these are the subject of our continuing study and may be proposed to the Congress at a subsequent date.

To secure the benefit of industry views on our legislative proposals, we shall immediately request leaders of the financial community to form liaison committees.

IV

The Report of the Special Study is a major contribution to the understanding of the operations and problems of the securities markets. In its collection and analyses of data, it provides a thorough and responsible foundation for action. Furthermore, the enactment of Public Law 87–196 and the very existence of a Special Study have assisted in the creation of a more salutary environment and have resulted in numerous important developments. The American Stock Exchange has undergone an intensive reorganization. The New York Stock Exchange has commenced a program for improved controls over selling practices and initiated new qualification standards. The NASD has undertaken a comprehensive revision of its bylaws and Rules of Fair Practice. Broker-dealers have reviewed and altered their systems of supervision. It would go too far to assert that all of these, and other numerous changes, are the direct products of the Special Study and of the initiating legislation. Yet it would be difficult to deny that their existence has at least produced a reevaluation of existing practices and procedures by the industry, as well as the Commission, which can only be beneficial. In other words, the financial community has taken the opportunity to make its own special study, with valuable consequences.

As has been pointed out throughout this letter, the Report of the Special Study is only a prelude; it discloses many problems whose resolution will require the efforts of the Commission, the exchanges, the NASD and the industry itself. To these we will now turn our attention. Our legislative recommendations to the Congress will be an important first element, indeed a prerequisite for needed improvements. However, much of the action may be taken through the self-regulatory agencies, through exercise by the Commission of existing powers and through the influence of leaders in the securities industry to raise standards.

In concluding, the Commission wishes to express its appreciation to the members of the financial community, the self-regulatory institutions and the numerous companies that fully cooperated with the Special Study. Many gave generously of their time and manpower in assisting the study to gather information and viewpoints.

The superlative efforts of the staff of the Special Study and its supervisors must be especially singled out. All worked tirelessly and with a fine understanding of the heavy responsibility they were obligated to discharge. The Commission was uniquely and most strongly served in having Milton H. Cohen as Director, Ralph S. Saul as Associate Director, Richard H. Paul as Chief Counsel, Sidney M. Robbins as Chief Economist, and Herbert C. Schick as Assistant Director. Not to be overlooked are the contributions to the study in counsel and data collection of many persons in the operating divisions and offices of the Commission.

By direction of the Commission:

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 17, 1963.

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIR: I have the honor to transmit the second segment of the Report of the Special Study of Securities Markets, containing chapters V, VI, VII, and VIII. This report is submitted pursuant to section 19(d) of the Securities Exchange Act of 1934, Public Law 87–196, which directs the Commission to make a broad study of the adequacy of investor protection in the securities markets. The first installment of this report, chapters I through IV and IX, was delivered to the Congress on April 3, 1963; the final installment should be transmitted within the next few weeks.

The chapters of the report here transmitted deal with the trading markets, the exchange markets and the over-the-counter market. As we stated in our first letter of transmittal, this report should not impair public confidence in the securities markets, but should strengthen it as suggestions for raising standards are put into practice.

I

There is a wide diversity among the various markets. An exchange market is concentrated in a single place and has a limited group of professional participants, as well as a selected list of traded securities. The over-the-counter market, on the other hand, has no boundaries;

it is everything outside the exchange markets. It is scattered throughout the country and represents in essence the sum of many markets. It is characterized by unlimited entry both from the viewpoint of securities traded and persons trading. It is vast, diffuse and heterogeneous. Indeed, there was no composite picture of the over-the-counter market today until this study was completed.

Because of these differences the markets have received different regulatory treatment. The report points out the more extensive, and intensive, degree of controls over trading practices in the principal exchange markets as compared with the over-the-counter market. Consequently, the problems and needs of the over-the-counter market appear greater. But in both markets there are serious inadequacies in investor protection. Certain of these shortcomings have been of continuing concern to the Commission, such as floor trading in the principal exchange markets. Others are presented in a new context, as in the case of the odd-lot dealers. In still other situations, the Special Study has amassed the technical data necessary for a thorough analysis, for example, of the specialist system or of the operation of the over-the-counter market. Finally, the study affords a unified picture of the markets which previously have been viewed only in more or less isolated fashion. Thus, we are now in a position to appreciate the effect of the New York Stock Exchange commission rate schedule on the regional exchanges and the evolution of the "third market."

The study has properly focused on problem areas. To these the Commission, the self-regulatory agencies, and the financial community must respond with promptness and thoroughness. The importance of the capital markets to our economic progress does not permit otherwise.

II

As we said with respect to part I of the report, we have been exceedingly fortunate to have assembled such a superior group to conduct the study. The Special Study was given freedom to analyze and point out problems as they appeared to it; in this respect, the judgments, analyses, and recommendations in the report are those of the Special Study and not the Commission.

In connection with this installment, we highlight three further points. In the first place, we emphasize that the recommendations in this part of the report, with the important exception of controls over operators of quotations bureaus, can be effected, without amending the securities acts, through the medium of the rulemaking authority of the Commission or of the self-regulatory agencies. Moreover, as the Congress is aware, the Commission has made legislative recommendations which have been embodied in S. 1642, H.R. 6789, and H.R. 6793. These recommendations are substantially based upon and supported by the first installment of the Report of the Special Study. The Committee on Banking and Currency, U.S. Senate, has reported out S. 1642, as amended. It is the Commission's opinion that these bills represent essential amendments to the securities laws and that their enactment will significantly improve investor protection. Improvement will be achieved not only through more reliable disclosure as to companies traded in the over-the-counter market, but in the market itself, through raising qualification standards for those dealing in over-the-counter securities. We further point out that, although our legislative

program is a part of a general effort to raise standards in the securities markets, the program stands by itself; thus consideration of the bills can appropriately proceed independently of the discussion and resolution of the questions raised in the chapters here transmitted.

Secondly, as we have indicated, this section of the report contains recommendations designed to be carried out by the Commission under its rulemaking power or by the self-regulatory agencies. It is inappropriate, therefore, for us to speak definitively on various of the questions presented, which involve substantive changes in our rules or the rules of the self-regulatory agencies. In most cases, we cannot legally take final action until interested persons are afforded an opportunity to present their views. In other instances, a hearing and the making of a record may be necessary. In any event, we believe the responsible course of action calls for discussions with the securities industry before any final decisions are made.

Finally, as the study itself has so carefully pointed out, these problems are subtle and complex; many are just emerging, and many call for further study. Some subjects, such as automation, are long-range in nature, far-reaching in impact, and require a continuing and more elaborate analysis of a development only in its infancy in the securities industry. Many other recommendations are of a similar nature. For example, any conclusions about certain of the recommendations concerning the over-the-counter market must await further exploration and consultation with the industry. Similarly, any proposals regarding the structure of the New York Stock Exchange commission rate schedule must be premised upon a thorough understanding of the impact any change in that structure would have on other sectors of the securities markets, such as the regional exchanges.

These considerations, of course, do not preclude our endorsement of the general soundness of the report as a point of departure for discussion with the industry and for rulemaking. They do serve as a background to a more detailed response by us to the recommendations. We recognize that the Congress expects such a response, as evidenced by a letter dated April 5, 1963, from the Honorable Oren Harris, chairman, Committee on Interstate and Foreign Commerce, House of Representatives, requesting our views as to the specific recommendations contained in the first part of the report. We expect to send a letter within the next few days detailing our views on the specific recommendations in the second installment.

III

At the present time the Commission's efforts are heavily committed to our legislative program which is under consideration by the Congress and to the completion of the Report of the Special Study. Upon completion of these efforts, we shall concentrate upon those areas calling for exercise of our rulemaking authority or that of the self-regulatory agencies. In the meantime, the staff of the Commission is preparing proposals for presentation to the Commission and to the industry. A special Office of Program Planning has been established whose initial task will be to coordinate and assist the operating divisions and offices of the Commission in this large and very important task of carrying out recommendations of the Special Study.

By direction of the Commission:

WILLIAM L. CARY, *Chairman.*

96-746—63—pt. 5——2

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 8, 1963.

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIR: I have the honor to transmit the final installment of the Report of the Special Study of Securities Markets containing chapters X through XIII. This report is transmitted pursuant to section 19(d) of the Securities Exchange Act of 1934, Public Law 87-196.

I

As directed by the Congress, the whole report is a broad study of the securities markets and a commentary on the adequacy of investor protection in those markets. As we indicated in our first letter of transmittal, the report demonstrates that, although serious problems do exist and additional controls and improvements are much needed, the regulatory pattern of the securities acts does not require dramatic reconstruction. In important respects this pattern has been effective, efficient, and adaptable; it has advanced and guarded investor participation in our economic growth. The functions of this report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence.

II

The chapters here submitted deal with diverse subjects, including the adequacy of the structures and practices of the self-regulatory agencies, security credit regulation, mutual fund selling practices, and events surrounding the market break of May 1962. As in the case of prior sections of the report, the Special Study was given freedom to analyze and point out problems as they appeared to it; in this respect the judgments, analyses, and recommendations in the report are those of the Special Study and not the Commission. We strongly endorse the general soundness of these chapters as a basis for discussion with the industry, for rulemaking, and for legislative proposals. Without public notice and comment, we may not speak definitively on those questions involving substantive changes in our rules or the rules of the self-regulatory agencies. In any case, we believe the responsible course of action calls for discussions with the securities industry before final decisions are made.

Rather than taking up the chapters in order, we shall first focus on chapter XII—which analyzes the role of the self-regulatory institutions and their relation to the Commission.

A

In section 19(d) of the Securities Exchange Act, the authorizing resolution for the Special Study, the Congress emphasized an examination of the adequacy of the rules of the self-regulatory agencies. The whole report is a comment on this theme. Chapter II evaluates the rules of the NASD and of the principal exchanges relating to qualifications and chapter III those governing selling practices and invest-

ment advice. Chapters VI and VII examine the rules and procedures of the self-regulatory agencies with respect to trading practices in the exchanges and over-the-counter market. Chapter XII, transmitted today, analyzes the organization and self-regulatory operation of those agencies, with primary emphasis on the New York Stock Exchange and the National Association of Securities Dealers, Inc., and their relationship to the Commission and each other.

We agree with the report that "the basic statutory design of substantial reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas." This conclusion obviously does not minimize in any way the need promptly to remedy the disclosed inadequacies, a need more critical as increased reliance is placed on the self-regulatory agencies—which this report and the Commission contemplate.

1

The New York Stock Exchange occupies an unrivalled position as a self-regulatory institution because of its importance as a market and because of the dominant position of its membership in the securities business. We believe it important to point out, first, that the study quite properly devoted particular attention to problem areas and, secondly, that, although there are defects in the functioning of the Exchange market which should be corrected, the Exchange has worked diligently, and on the whole successfully, to maintain a fair and honest market. The report points out the strong performance of the Exchange in many areas, including qualifications and net capital. Its disclosure and related requirements, some antedating the enactment of the Federal securities laws, represent a major contribution to investor protection and, in some respects, have gone beyond anything the Commission could do. In certain areas, judged by the Exchange's own standards of accomplishment, performance has been less satisfactory. For example, controls over branch office operations and investment advisory and selling practices require strengthening; the Exchange itself has recognized this in its initiation of new programs. The report discloses a failure of regulation over odd-lot dealers and raises serious questions about floor trading. The Special Study's examination of the Exchange's specialist system reveals no widespread abuses or patterns of illegality. On the other hand, there are subtle and complex problems discussed in the report which call for examination and review by the Exchange and the Commission with a view to strengthening the system and raising the quality of operation of some segments to that of the most effective and most efficient.

Moreover, disciplinary action does not appear to have been as forceful as circumstances have warranted. With regard to the organization of the Exchange, the report points to a need for a reallocation of voting power among members and allied members in order to give firms dealing with the public more responsibility in the government of the Exchange.

The importance of the New York Stock Exchange as a self-regulatory institution and as a market makes it imperative that it bring its entire level of performance up to its demonstrated capabilities. The recommendations in chapter XII-B of the report and elsewhere are designed, as the report states, "to point toward an even stronger

future role" for the Exchange. With limited reservations in two instances which are footnoted below, we agree with these recommendations.[1]

2

Early in 1962 the Division of Trading and Exchanges of the Commission, in conjunction with the Special Study of Securities Markets, issued a report concerning the American Stock Exchange. This report pointed out serious problems in regard to the operations of that exchange and practices occurring on its floor. The American Stock Exchange, together with selected representatives from the securities industry, and in consultation with the Commission, has since engaged in a substantial reorganization of its management, constitution, and operations. As the report concluded in subchapter XII–C: "In contrast to the prior breakdown of self-regulation described in the staff report, the accomplishment of this reform appears to be an excellent demonstration of the effectiveness of self-regulation under responsible exchange leadership and active Commission oversight." It is apparent that the American Stock Exchange has now instituted a responsible regulatory system as a basis for meeting its obligations under the Exchange Act, including problems it shares with the NYSE.

The Special Study made a more limited examination of the regional exchanges, with primary emphasis on the Midwest and Pacific Coast stock exchanges—the major regional exchanges. We agree with the recommendations with respect to these exchanges in subchapters XII–D, XII–E, and XII–F of the report.

3

The primary responsibility of the National Association of Securities Dealers, Inc., is to regulate the conduct of its members in the over-the-counter market. Because the over-the-counter market is scattered throughout the country, includes all varieties of securities, and is open to all persons, the NASD's job is a difficult one. Its role will become more important, since many recommendations in the report call for increased activity on the part of the NASD in both policymaking and enforcement.

The work of the NASD is in large measure performed by its members who volunteer their time and effort to the job of self-regulation. The NASD has established important standards of business conduct, including restrictions against unconscionable underwriting compensation and rules dealing with "free-riding." It has assisted in the general enforcement efforts against overreaching and abuses in the over-the-counter market. However, there are many key areas in need of improvement in the over-the-counter market, in terms of new standards, as well as strengthened enforcement programs. In this context,

[1] As to the recommendations in item 2, we favor steps looking towards a more representative distribution of voting power among regular and allied members. We will explore further the need for altering the composition of the governing bodies of the Exchange. With respect to item 7, the obligation of the Exchange, of which it is not unmindful, to avoid exaggerations and misunderstandings in its advertisements is clear. Whether any further restrictions should be placed on the Exchange's public relations activities is not so clear. The Commission has encouraged the Exchange to undertake the supervision of the advertising of its member firms, including advertising of an institutional character, some of which is the work product of the Exchange's own staff. The Commission is not now prepared to dispense with the advantages of the present system without further examination of the problem.

certain organizational characteristics, including the emphasis on member participation and the heavy demands on the Board of Governors, necessitate significant rethinking and redirection. More effective regulation requires a larger staff—a direction in which the NASD has been moving during the last few years—with increased responsibility and a reallocation of work among member participants in the government of the NASD. The participants would then have more opportunity to consider general policy and the NASD could better carry its formidable workload.

We agree with all of the recommendations of the report in subchapter XII–G which are designed to strenthen the organization of the NASD and make its operations more effective.

4

The fundamental issue of the relationship between the Commission and the self-regulatory agencies requires special comment. The report states in chapter XII–I that "regulation in the area of securities should, in short, be a cooperative effort, with the Government fostering maximum self-regulatory responsibility, overseeing its exercise, and standing ready to regulate directly where and as circumstances may require." We subscribe to this statement of policy and generally agree with the specific recommendations in chapter XII–I. The obligations of the self-regulatory agencies should be increased, through both their adoption of rules in many areas and their assumption of new enforcement duties—including certain duties now borne by the Commission.

The failure of the self-regulatory agencies to operate at maximum capacity and with full regard for the public interest in certain areas is in part attributable to the Commission's own failure to provide the necessary continuing guidance and oversight. We are certain that the present statutory pattern permits more effective and more pervasive self-regulation than has yet been achieved. Undoubtedly this will require a reorientation of our present procedures in the directions suggested by the report's recommendations. For example, under section 19(b) of the Exchange Act, we have a duty to review exchange rules to determine whether they are consistent with the protection of investors. We should place more emphasis on newly adopted rules than is now the case. Thus, our present arrangements with regard to the exchanges' notification to us of rule changes prior to their adoption might be revamped along the lines of the procedures worked out with the New York Stock Exchange respecting changes in the minimum commission rate schedule. With respect to the NASD, our authority to alter or amend their rules is more limited than in the case of the exchanges. We have, however, direct powers over practices in the over-the-counter market, in many respects unexercised, which can be utilized. Until these have been fully exercised and found wanting, we shall not ask Congress for legislation. In any event, up to this time needed improvements have been secured after conferences and discussions with the NASD.

We shall examine with the exchanges the need for further procedural safeguards for those affected by exchange actions—a problem that has taken on new significance because of the recent Supreme Court case of *Silver* v. *New York Stock Exchange*. In addition, as

suggested by both subchapters XII–I and XII–J, we will confer with the self-regulatory agencies to determine methods by which enforcement and inspection responsibilities can be better allocated between the Commission and the self-regulatory agencies and among those agencies themselves.

One sector of the self-regulatory scheme will require joint analysis with the exchanges of the need for legislation. In the *Silver* case the Supreme Court held that the termination, at the order of the New York Stock Exchange, of wire service from its members to a nonmember, without any hearing afforded the nonmember, involved a violation of the antitrust laws.

We believe it essential that the *Silver* decision should in no way be construed to inhibit vigorous performance by the exchanges of their self-regulatory responsibilities. We are confident that the Supreme Court intended no such result: indeed the Court emphasized "the federally mandated duty of self-policing by exchanges." Steps can and must be taken to avoid any possible problems. These could include appropriate procedural changes by the exchanges and careful analysis of the need for some form of review of exchange actions by the Commission. If review procedures are thought necessary, legislation may be required.

Our firm conviction is that self-regulation, an essential ingredient in investor protection, must continue in a strong, forward movement. Accordingly, we have written to the New York Stock Exchange advising of our concern and shall undertake to resolve with it any problems presented by the *Silver* case.

B

In chapter X, the report has examined security credit regulation as a factor in the securities markets. This regulation, of course, has broader aims: it is an instrument for credit control in the economy. As such, it is the primary concern of the Board of Governors of the Federal Reserve System. Accordingly, as the Special Study has pointed out, recommendations in this area including legislative proposals relate essentially to matters within the jurisdiction of the Board of Governors. The Commission believes that all the recommendations of the study have merit, but, recognizing the paramount authority of the Board, will not initiate any action. We shall work closely with the Board towards the resolution of the problems raised.

The staff of the Special Study received generous assistance and cooperation from the staff of the Board of Governors who reviewed chapter X from a technical point of view and who also prepared all of the appendixes. Of course, none of the Reserve personnel, nor the Board, is in any way responsible for the final views expressed in the chapter.

C

Chapter XI of the study deals with selected aspects of open-end investment companies, so-called "mutual funds," including selling practices, contractual plans, insider trading in portfolio securities and portfolio-brokerage reciprocal business patterns. It must be emphasized that this chapter should in no way be construed as a reflection upon the investment merits of mutual fund shares, upon the investment company as an important vehicle for investment, or upon any particular company. Furthermore, it should also be emphasized that

the questions raised with respect to contractual plans do not, and should not, affect present holders of these plans. As the study has stated, its analysis should not be taken by any planholder as a reason for redeeming any plan certificates. Early redemption of a plan almost invariably results in loss to the planholder. The problems analyzed by the report are in no way related to the merits of the underlying investments or to shares bought outright. The recommendations are focused solely on *future* contractual plans as distinguished from plans already entered into.

Contractual plans involve the purchase of mutual funds on an installment basis, with a substantial portion of the initial payments—up to 50 percent—taken out for sales load in the first year. Their sponsors justify this deduction on the ground that it provides a necessary stimulant to saving. The report has raised serious questions about contractual plans, basically revolving around the first year sales load deduction. As chapter XI–B recommends, steps should be taken to deal with the problems disclosed. Discussions will commence with the industry immediately; but definitive action, whether legislation or otherwise, will await the completion of our general structural study of mutual funds.

In chapter XI the report also analyzes mutual fund selling practices, reciprocal business activities, and potential conflicts of interest related to insider trading in fund portfolio securities. With the limitations footnoted below, we agree with the accompanying recommendations.[2]

As the Congress is aware, on August 27, 1962, the Commission transmitted to the Congress "A Study of Mutual Funds," representing a factfinding survey of certain aspects and practices of open-end investment companies. This study was prepared by the Wharton School of Finance and Commerce of the University of Pennsylvania. At the same time, the Commission requested its Division of Corporate Regulation to undertake a detailed analysis of the Wharton School Study and conduct its own examination into structural problems of mutual funds. That examination should be submitted to the Commission sometime late this year or early in 1964. Meanwhile, chapter XI of the report represents an important contribution to the overall picture.

D

Chapter XIII of the report deals with the events surrounding the severe market break of May 1962. This chapter was specifically promised at a congressional hearing. The report draws upon data collected by the New York Stock Exchange and also its study of May 28, 29, and 31. The report presents additional data with respect to transactions by institutions, foreign investors, and members and also an analysis of transactions in selected stocks.

As pointed out in subchapter XIII–E, neither the report of the study nor that of the New York Stock Exchange was able to isolate and identify the causes of the market events of May 28, 29, and 31. Moreover, contrary to some speculation at the time that the events

[2] With respect to item 2, subch. XI–B, we shall examine various ways by which our prospectus requirements for mutual funds can be further refined. Finally, with respect to the recommendation of subch. XI–D, we believe that each registered investment company should adopt, and take appropriate steps to enforce, a written policy concerning insider trading along the lines suggested in this recommendation.

might be the result of some conspiracy, neither of these reports presents any evidence that the break was deliberately precipitated by any group or resulted from manipulation or illegal conduct in the functioning of the market.

The study—after noting the extreme nature of any action by the Commission suspending trading under section 19(a)(4)—recommends that the Commission and the industry should make a joint study of possible measures which might be taken by the Exchange "to assure minimum disruption of the fair and orderly functioning of the securities markets * * *." We interpret this to mean measures to improve the efficiency and effectiveness of the operations of market mechanisms during periods of severe market stress.

The Exchange, of course, has at its disposal a number of measures to deal with unusual conditions in the market place and invokes these from time to time on a security-by-security basis as, for example, the controls exercised over "openings" and the temporary suspension of trading in particular securities.

The Special Study was not able to address itself to the manner in which these measures were or might have been employed with particular reference to the events of May 28–31. The material published by the Stock Exchange likewise does not deal with this specific question.

The various recommendations made elsewhere in the report, in part upon the basis of data relating to the market break, with respect to such matters as short selling, the capital position of specialists, floor trading and odd-lot transactions, should improve the ability of the mechanism to function more effectively in normal periods as well as in times of stress. It seems clear that, in the course of our consideration of these matters with the Exchange, events leading up to and during the market break must inevitably join the considerable array of complex and, to some degree, technical factors which must be weighed in reaching decisions. We agree that it would be desirable for the Exchange to review the data accumulated in the course of the two studies, with particular reference to whether the procedures available to it were employed always as fully or as effectively as they might or should have been and whether sound policy would suggest some changes, and whether it is feasible or necessary to obtain additional trading information. The results of this review could thus be available to assist both the Exchange and the Commission in seeking solutions to some of the problems described in the report. Certainly, it would seem that the performance of some specialists during the market break was not considered satisfactory by the Exchange itself; moreover, it is not clear why the machinery for handling some odd-lot orders should have failed as it apparently did. These and similar matters deserve the particular attention of the Exchange and of the Commission in the exercise of its oversight. It should be kept in mind that the role of the Commission, and that of the Exchange, does not extend to "managing" price movements or purposefully affecting prices.

III

This transmittal completes the Report of the Special Study of Securities Markets. The report is clearly the most thorough examination of the securities markets since the early 1930's. Size alone is but a poor measure of its importance and achievement. The report would

have high usefulness if only for its orderly presentation of basic facts about the markets. More importantly it offers a foundation for regulatory and industry actions for a long period to come.

Implementation of the report can be prompt in many cases. Fundamental recommendations of the Special Study have already been incorporated in the Commission's legislative proposals, embodied in S. 1642, as amended, H.R. 6789, and H.R. 6793. S. 1642, as amended, has passed the Senate and, together with H.R. 6789 and 6793, is now pending before the House of Representatives. It is our judgment that these bills represent essential amendments to the securities laws. By providing for more reliable and extensive disclosure as to companies traded in the over-the-counter market and by raising qualification standards for those dealing in over-the-counter securities, enactment of the bills will have a pervasive impact on the raising of standards in the securities markets and will serve as a base to achieve many of the improvements suggested by the study. At the same time, as we noted in connection with the transmission of chapters V through VIII, the legislative program stands by itself; thus consideration of the bills can appropriately proceed independently of the discussion and resolution of the questions raised in the chapters here transmited.

We do not plan to submit any further legislative proposals to the Congress this session. We may at a later session recommend legislation relating to quotations bureaus and to review of exchange actions—the latter only if it is found necessary after further analysis of the *Silver* case. Furthermore, we shall work with the Federal Reserve Board in any program respecting security credit regulation which they believe should be submitted to Congress.

In addition to our legislative proposals, substantial benefits have resulted since the institution of the study. Some of these are summarized in subchapters XII-B and XII-G. Many more will result as the report is carefully and selectively implemented. We will work expeditiously and in conjunction with the securities industry on the numerous recommendations requiring rulemaking on our part and on the part of the industry agencies. Certain areas, such as the impact of automation on the securities industry, are clearly long range in nature and require continuing and elaborate analysis before decisions can be reached.

IV

In measuring others, we must measure ourselves. As we said in our first letter of transmittal, while the report focuses upon the shortcomings in the industry and in the self-regulatory agencies, in certain respects it is an express or implied criticism of the Commission as an institution. For example, on the exchange side, the failure to regulate odd-lot activities and, on the over-the-counter side, the lack of more specific standards and of more effective enforcement procedures in certain sectors represent problems unsatisfactorily resolved by the Commission. We have at times been hampered by a lack of personnel or concentrated on particular areas. Further, we, like the self-regulators, have been preoccupied with day-to-day problems and have not been able fully to perceive new trends and weaknesses which arose with the expansion of the securities markets—an occurrence in itself intensifying the routine administrative tasks as well as creating new problem areas. However, institutions—government, quasi-public or

private—all benefit from reexamination. It has required a Special Study, detached from involvement with routine, but necessary, tasks, to produce a comprehensive, overall view of securities regulation. But what we have done is not so important as what we must do—and that must be the case with the self-regulatory agencies and the financial community as well.

* * *

In concluding, the Commission would again like to acknowledge the cooperation offered throughout the conduct of the study by members of the securities industry, by the self-regulatory agencies, and by others in Government. We once more express our appreciation for the extraordinary work of the staff of the Special Study of Securities Markets under the leadership of Milton H. Cohen as Director, Ralph S. Saul as Associate Director, Richard H. Paul as chief counsel, Sidney M. Robbins as chief economist, and Herbert G. Schick as Assistant Director. The staff of the study has proceeded always in a responsible, thorough and craftsmanlike manner. We have indeed been fortunate to have retained the services of so many dedicated individuals from private law practice and industry, from the universities, from Government and from our regular staff. We are also grateful to the many in our operating divisions and offices who contributed much to the study in ideas, experience and information.

We believe that the study has fully justified the confidence entrusted in the Commission by the Congress in authorizing an examination of the securities markets.

By direction of the Commission:

William L. Cary, *Chairman.*

LETTERS OF TRANSMITTAL FROM THE SPECIAL STUDY OF THE SECURITIES MARKETS

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 3, 1963.

To the Chairman and Members of the Securities and Exchange Commission:

We have the honor to transmit herewith chapters I, II, III, IV, and IX of a report of the staff of the Special Study of Securities Markets. These are 5 of what is expected to be a total of 14 chapters in the complete report. The vast scope and size of the report and the complex nature of the problems with which it deals have unfortunately made it impossible to deliver the entire report to the Commission as a single unit at this time. The remaining chapters are all well advanced, with some segments entirely completed and others substantially so, and it is anticipated that they will all be delivered to the Commission by the end of May. The contents of the present chapters and those still to come are briefly identified below.

The total report will constitute the findings, conclusions, and recommendations of the staff of the Special Study as a result of its study and investigation, made pursuant to section 19(d) of the Securities Exchange Act, "of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations."

The study and investigation reported herewith have been carried on for the Commission by the staff of the Special Study under the direction of the undersigned. The report by its size reflects the intent of the Congress, as evidenced both by the language of the statute and its legislative history, that the Commission conduct a broad study of the rules, practices and problems in the securities industry and markets. The House committee report which preceded the enactment of section 19(d) pointed out that while the language of the section was specific, its scope was "very broad." A brief review of the content of the report indicates the breadth of the subject matter which it fell to the Special Study to review.

Chapter I of the report, after describing briefly the purposes and methods of study and the general nature of recommendations arrived at, sets forth general data highlighting the growth of the securities industry in the postwar period, which was an important reason for the study and provides the background for many of the subjects explored. Chapters II and III are concerned with the broad range of persons and business entities engaged in the securities business—broker-dealers, salesmen, salesmen's supervisors, and persons engaged in giving investment advice. The first of this pair of chapters examines the standards and controls relating to their entry into and

removal from the business; and the second their activities and responsibilities in the course of that business and the related controls. Chapter IV deals with primary and secondary distributions of securities to the public, with particular emphasis on new issues and briefer review of other specific areas such as registration of seasoned issues, unregistered distributions, intrastate offerings, and real estate securities.

Chapters V, VI, VII, and VIII extensively explore the functions, structures and problems of markets in which securities are traded after their distribution. Chapter V is a general introduction to this group of chapters. Chapter VI covers the exchange markets, with special attention to the most important of these, the New York Stock Exchange. The chapter reviews the functions and activities of various specialized categories of members, particularly specialists, odd-lot brokers and dealers, and floor traders, and also deals with the subjects of short selling and commission rate structures. Chapter VII discusses the over-the-counter markets, their vast and heterogeneous character, their wholesale and retail components, the quotations systems, and present controls over all of them. Chapter VIII then examines various interrelationships among trading markets, including patterns of distribution of securities among exchange and over-the-counter markets, institutional participation in various markets, over-the-counter trading in listed securities, and the regional exchanges as "dual" and primary markets.

Chapter IX reviews the legal requirements and standards in respect of reporting, proxy solicitation and "insider" trading which are applicable to issuers of securities in public hands, contrasting those relating to securities listed on exchanges with those relating to over-the-counter securities and emphasizing the need for legislation in the latter area. It also considers problems in the dissemination of corporate publicity by issuers of both kinds of securities. Chapter X deals with the purposes, effects, and enforcement of securities credit and margin regulations and some inconsistencies and anomalies of the present regulatory pattern. Chapter XI is concerned with certain aspects of open-end investment companies ("mutual funds") which are covered neither by the recent industry study conducted by the Wharton School of Finance and Commerce nor by continuing inquiries of the Commission's Division of Corporate Regulation. It contains the results of an investor survey and also specifically treats with selling practices, contractual plans, and certain problems in connection with fund portfolio transactions. Chapter XII deals with the self-regulatory pattern which is largely unique to the securities industry. It evaluates the regulatory functioning of the New York Stock Exchange, the American Stock Exchange, the principal regional exchanges, the National Association of Securities Dealers, Inc. and certain quasi-regulatory agencies, notes the absence of self-regulatory organizations in certain areas, and assesses the role of the Commission in relation to all of them.

The market break of May 1962 was thought to merit separate examination as a major market phenomenon, and also afforded an opportunity to study certain aspects of the securities markets, already studied under more normal conditions, in the circumstances of a precipitous decline. The results of this study are set forth in chapter XIII, although other chapters dealing with particular topics also reflect the findings of this special inquiry. Chapter XIV, still tenta-

tive in nature, is reserved for a few general topics that may fit neither within the scope of any of the previous chapters nor within the limits of a further transmittal letter.

In general, each of these chapters provides an intensive evaluation of the subjects indicated, based upon detailed questionnaires, public and private hearings, interviews with members of the industry, and review of existing data of many kinds. In addition to the basic analyses of this material, specific conclusions and recommendations are set forth in each chapter except I and V. When all chapters are completed, it is also planned to prepare a summary volume bringing together all of these conclusions and recommendations.

Ambitious though the scope of the investigation undertaken by the Special Study may have been, it still could not embrace the full potential of the enabling statute and its legislative history. In selecting those areas which it was felt could be thoroughly and responsibly studied within the limits of available time and manpower, it was necessary to exclude others of unquestionable importance. Among the subjects omitted from the study and report there are undoubtedly some that merit separate study by the Commission in the future.

* * *

In presenting a report of the size and scope of the present one, it is perhaps appropriate to add some general comments which reflect impressions resulting form the entire work of the Special Study but which may not find a place in the report itself. Other general comments may be added in transmitting the balance of the report.

The enormous growth of the securities markets experienced since the original enactment of the Federal securities laws, reflecting both the vigor of the industry's own activities and the general expansion of the country's economy and population in the intervening years, has been accompanied by many qualitative changes in methods, practices, controls, and standards. A basic objective of the Special Study was an evaluation, in the light of both quantitative and qualitative changes, of the theories and mechanics of direct governmental regulation and industry self-regulation originally envisaged by those laws. The study and report indicate that under the stresses of its expanded role the framework of regulation needs considerable adjusting and strengthening, but its basic design appears to have stood the test of time and to have worked effectively in most areas.

Since the Federal securities laws have been in force for a full generation, it is hardly surprising that the Special Study has not disclosed the prevalence of gross abuses such as were characteristic of the era which preceded their enactment. Nevertheless, as will be evident from the entire report, many serious problems do exist and important improvements are needed. It is inevitable that in reflecting the results of any investigation, a final report will give greatest attention to the problems uncovered and the areas in which the need for improvement is most pressing. Nevertheless, the emphasis in this report on present shortcomings should neither obscure nor detract from the many aspects of the securities business and its regulation and self-regulation which afford reason for pride and satisfaction. The strength of the American economy and its free-enterprise system both reflect and are dependent upon an investment banking system and market institutions that

are basically strong and sound, but this makes it all the more, rather than less, necessary to expose and correct the weaknesses and abuses that still exist. Many of the substantive recommendations in the report can, indeed, be regarded as attempts to raise the entire securities industry to the best standards which the industry itself proclaims and to the highest levels of attainment which some of its participants have in some sectors achieved.

Because of the number and variety of subjects covered it was, of course, necessary to devise sampling procedures of different kinds for different subjects. In each case the attempt was made to use as broad and representative a sample as possible while still holding down the total burden on members of the industry and distributing the burden among them as equitably as was practical. Nevertheless, it has undoubtedly happened that the names of some firms appear in the report, in connection with particular practices, incidents or viewpoints, more frequently than those of comparable firms. It should be recognized that the naming of any particular firm in this way, whether favorably or unfavorably, often means, not that the matter under discussion is unique to it, but that the processes of study and investigation happened to bring that firm's name to the fore, rather than another's, in the particular context.

Given the scope and complexity of the studies undertaken and the limited resources of time and manpower available, it would be presumptuous to suggest that the Special Study could propose complete or "final" answers to all the questions that call for answers. No such effort is made in the report. For some of the problems considered, fairly immediate and specific measures are recommended; for others, broader long-range programs are outlined; and for some of the most knotty there is merely an indication of possible approaches—sometimes alternative or multiple ones—that may point the way to future solutions.

Prompt adoption of the specific measures and rapid implementation of the longer range programs hopefully will be the earliest fruits of the study, but perhaps an equal contribution will have been made in the areas where solutions are least clear, for surely one goal of any study of this kind is to create a ferment of thought and discussion. Where the report has not itself produced answers, it may at least have posed the important issues for which the securities industry and regulatory authorities must seek solutions.

A corollary of prime importance is that broad-gaged studies of the kind undertaken by the Special Study cannot be once-in-a-generation affairs but should be a major part of the Commission's regular and continuous activities. To be able to see the forest instead of just the trees, to be able to evaluate current trends and future potentials as well as past results, the Commission should have a permanent staff group, small but expertly manned, that is free from routine administration and assigned the responsibility of observing and measuring important trends, identifying and evaluating new developments, and from time to time making special studies of particular subjects. By and large the functions of continuous study, long-range planning and broad policymaking have been too much subordinated to day-to-day administration, except for the very earliest years of the Commission's existence.

If the experience of the Special Study is any guide, not the least benefit of more continuous activities of this kind would be their in-

vigorating effect on the self-regulatory institutions and their admonitory effect on members of the industry generally. The period since the study began has witnessed a quite remarkable display of fence mending, roof patching and even foundation strengthening. Some of the specific items may have been merely coincidental, some may merely have represented acceleration of developments that would otherwise have occurred, but unquestionably many of them were in some degree a valuable byproduct of the study itself.

The original Federal securities laws of 1933 and 1934 were a remarkable legislative achievement, and have well served the needs for which they were designed for over a quarter century. Nevertheless the review of past experience and current conditions which has been completed by the Special Study makes evident the urgent need for some amendments which can make them as effective now and in the foreseeable future as they have been in the past. The tremendous growth of the financial community and of public involvement in the securities markets, the increased importance of the over-the-counter markets, and the immense improvements in means of communication and data-processing, account for the major legislative recommendations of the report. In the chapters presently transmitted, the principal such recommendations are for stronger controls over entry into the securities business and better disclosure protections for investors in over-the-counter securities.

Another category of desirable amendments would be those designed, not to provide new protections, but to make existing ones more flexible and adaptable. The problems of today are more complex and subtle than the gross abuses disclosed in the hearings that followed the traumatic experience of the 1929 market crash, and more flexible instruments are needed to deal with them. In many areas the Commission today must either take drastic action or take none at all. It may revoke a broker-dealer's registration for a violation of law, but it may not proceed administratively against an individual perpetrator of the violation. It may impose no sanction to enforce the obligations of an exchange other than suspension or withdrawal of its registration. It may, with the approval of the President, suspend trading on an exchange for up to 90 days but it has no lesser powers to deal with periods of general market crisis. Various intermediate powers are needed to enable the Commission to avoid the hard choice between no action and excessive action.

An impression repeatedly and forcefully brought home in the course of the study is that aggregated or averaged data, although of unquestionable importance and usefulness for many purposes, may be useless or misleading in arriving at conclusions on some types of questions. To give a few of many possible examples: the average percentage of institutional transactions for all securities may obscure the fact or miss the point that institutional transactions in particular securities can be many times the average for all securities; the total quantity of short selling or floor trading over a period of time in all securities may mask the significance of crucial transactions at particular times in particular securities; averaged or aggregated figures for specialists as a class may conceal great disparities in the performance of individual specialists.

It is quite clear from the study that the data now compiled and used routinely for many purposes of regulatory surveillance and public information are inadequate or misleading in showing only totals or

averages where particulars or ranges are needed. The aim of many separate studies in the course of the Special Study was precisely to go behind available aggregated data and provide crucial "disaggregated" data. It may be open to dispute whether the Special Study has always succeeded in carrying out this aim, but the lesson for the future seems clear: Both the self-regulatory agencies and the Commission need to give consideration to the many places where presently provided data, in aggregated or averaged form, appear inadequate for regulatory needs or public information.

One final general comment is in order at this time. If the securities industry is to operate on the level of ethical standards at which its regulatory and self-regulatory organizations aim, it is important that the public's understanding of the securities markets and the securities business not be clouded by many illusions and misconceptions which now surround them. It is an excellent thing to aspire toward high standards of professionalism, undivided loyalty to customers, expert and unbiased investment advice, more responsibility of specialists, greater diligence and responsibility of underwriters, more liquidity and stability of markets, stronger regulatory and self-regulatory protections, and so forth—the list is legion—but it is an entirely different thing to encourage the investing public to believe that the aspiration is now the fact. Mere lipservice or exaggeration in these matters may do more harm than good, because the investing public may be led to expect too much in the way of certainty and protection, may fail to appreciate the risks inherent in investment, and may not exercise the vigilance and care required of the investor even under a statutory philosophy that emphasizes caveat vendor instead of caveat emptor. Perhaps the most pressing need of all, without any diminution of efforts to improve the securities markets in the respects mentioned and in other respects, is to foster accurate and realistic public understanding. This has been a major function, and hopefully will be a major result, of the Special Study and its report.

* * *

The report is the product of the staff of the Special Study of Securities Markets, which has varied in number from time to time but has averaged approximately 65 persons, of whom about half were attorneys, economists, analysts, and investigators, and the balance were clerks, secretaries, and stenographers. It is impossible adequately to express appreciation for the diligent efforts and sacrifices on the part of everyone who participated in the enormous task with which the Special Study was faced.

The study operated with a flexible organization under which all personnel were available for whatever duties needed to be performed, and no person has been exclusively responsible for any part or parts of the report. The work of the study was divided into more than 30 separate projects, each of which had a project head and 1 or more contributors. Some persons headed one or more projects and contributed to others, while other persons made substantial contributions to a number of projects. It would be invidious to single out individuals for special mention, except for a few who, if there had been a more formal organizational structure, would undoubtedly have had supervisory titles reflecting their actual roles: Robert L. Knauss, Robert N. Leavell, Martin Moskowitz, Frederick Moss, Norman S. Poser, Eugene H. Rotberg, Arthur J. Rothkopf, and David Silver.

Other members of the professional staff, each of whom contributed importantly to the study and report, were: Special editorial assistant: Roy A. Schotland; attorneys, James E. Bacon, Robert J. Birnbaum, James Hallisey, William C. Mammarella, Richard M. Meyer, Allan S. Mostoff, Lawrence W. Newman, Stephen J. Paradise, Ira H. Pearce, Sheldon Rappaport, Stanley Sporkin, Gary J. Strum, and C. Howard Thomas, Jr.; economists and statisticians: Leslie P. Anderson, Rolf Kaltenborn, Jonathan V. Levin, Helen K. Steiner and Robert Tucker; financial analysts: Harry Krueger, Bruce J. Simpson, Stuart R. Allen, Fred Siesel, Charles C. Sharpe, and Lois E. Zazove; investigators: Carmine Asselta, John E. Connor, Frederick Richard, Daniel Schatz, and Harry Zimmerman.

The study and report also depended heavily on the cheerful and unflagging efforts of Juanita L. Ward, administrative assistant, and of the entire clerical and secretarial staff. The clerical staff included Charles M. Atwell, Ann Hebert, Ann R. Heymann, Fred Horowitz, Margaret C. Hull, M. Karen Patten, Toby Orenstein, Joan R. Oxman, J. Michael Schaefer, Richard G. Schwartz, Gerald C. Spencer, Irma L. Weidowke, and Susan G. Wendeburg. The secretarial staff included: Ivadel E. Scarborough, secretary to the Director; S. Marie Kemet, secretary to the Associate Director; Rhoda S. Pines, secretary to the chief counsel; and Leah Ann Hare, Rebecca S. Klein, Dolores J. Lella, Catherine M. McDaniel, W. Loretta McEnroy, Mildred L. Reid, Elsie M. Rule, Jeannine A. Replogle, Ethel L. Shiro, Betty J. Snead, Helen G. Wallick, Marie G. Waterman, and Pauline Zinkle. The filing staff included: Leslie D. Shelton and Willis T. Shepard.

The study has also benefited from the contributions of several special consultants, including Prof. Thomas G. Gies of the University of Michigan; Prof. Richard W. Jennings of the University of California School of Law; Prof. James E. Walter of the Wharton School of Finance and Commerce of the University of Pennsylvania; and Profs. Irwin Friend, Andrew Brimmer, and Arthur Freedman, who, as members of the Securities Research Unit of the Wharton School, were employed by the Special Study to conduct a special survey of mutual fund investors.

While the staff of the Special Study is responsible for the content of the report, it could never have completed its appointed task without the wholehearted cooperation of the regular staff of the Commission. It would be hopeless to attempt to name individually the members of that staff whose efforts have lightened the burdens of the Special Study or assisted in its endeavors. Nevertheless, special mention must be made of the help received from the staffs of: the Division of Trading and Exchanges, including Philip A. Loomis, Jr., Director; Irving M. Pollack, Associate Director; Robert Block, chief counsel; Charles R. McCutcheon, Assistant Director; Vito Natrella, Assistant Director; Thomas W. Rae, branch chief; and Robert J. Bretz, Charles A. Cole, Elaine Sameth, Judith Schoenberg, Warren S. Shantz, and John Woodward; the Division of Corporation Finance, including Edmund H. Worthy, Director; Walter Werner, Associate Director; Charles E. Shreve, Executive Assistant Director; Robert H. Bagley, Assistant Director; Ralph C. Hocker, Assistant Director; Patrick J. Griffin, Jr., branch chief; Murray B. Weiner, branch chief; Stuart F. Feldman, Peter D. Lowenstein and Joel J. Rabin; the Division of Corporate Regulation, including Allan F. Conwill, Director; Gordon Henderson, Associate Director;

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J. Arnold Pines, chief financial analyst; and Meyer Eisenberg, assistant chief counsel; the Office of General Counsel, including Peter A. Dammann, General Counsel; David Ferber, Associate General Counsel; and Walter P. North, Associate General Counsel; the executive staff of the Commission and particularly Arthur Fleischer, Jr., executive assistant to the Chairman; Orval L. DuBois, secretary; William E. Becker, chief management analyst; and James F. Duffy; Ernest L. Dessecker, records and service officer, and the duplicating unit and the graphic arts section under his direction; and Frank J. Donaty, comptroller, and the machine tabulating unit under his direction. Assistance came also from each of the regional offices in suggestions and advice, and particular cooperation in investigations was extended by the administrators and staffs of the Boston regional office, the Chicago regional office, the Fort Worth regional office, the Los Angeles branch office, the New York regional office, the Seattle regional office, and the Washington regional office. Lastly, the Special Study is immeasurably indebted to the Commission itself for its suggestions, encouragement, constructive criticism, and patience.

The Special Study is indebted, also, to other agencies of the Federal Government for their cooperation. The Federal Reserve Board played a susbtantial role in the study's investigation of security credit and margin requirements, and particular advice and assistance were provided by Guy E. Noyes, Lewis N. Dembitz, J. Charles Partee, and Ann P. Ulrey of its officers and staff. The Bureau of the Census and the Federal Trade Commission each rendered important assistance in the processing and tabulating of statistical data appearing in the report, and the U.S. Tariff Commission made available its facilities for the public hearings conducted by the Special Study.

In closing it is most appropriate to express the gratitude of the Special Study for the cooperation of the industry itself, without which the study could never have accomplished what it has. It is perhaps the best measure of the success of self-regulation in the securities industry that both the self-regulatory agencies and the members of the industry itself continuously assisted rather than obstructed the inquiries of the Special Study, and bore with far less protest than might have been anticipated all of the extra burdens which the study unavoidably imposed. It is the hope of the Special Study that the patience with which the industry bore its investigation may be rewarded through conclusions and recommendations of the Special Study which, if in some cases initially unwelcome, may ultimately prove beneficial to the industry itself, to the investing public, and to the country as a whole.

Respectfully submitted.

MILTON H. COHEN,
Director,
RALPH S. SAUL,
Associate Director,
RICHARD H. PAUL,
Chief Counsel,
SIDNEY M. ROBBINS,
Chief Economist,
HERBERT G. SCHICK,
Assistant Director,
Special Study of Securities Markets.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 16, 1963.

To the Chairman and Members of the Securities and Exchange Commission:

We have the honor to transmit herewith chapters V, VI, VII, and VIII of the Report of the Special Study of Securities Markets. These chapters deal with trading markets for securities and are to be printed as part 2 of the total report. Chapters I, II, III, IV, and IX have been previously submitted under our transmittal letter dated April 3, 1963. The remaining chapters of the report should be ready to be forwarded to you within the next few weeks.

As we stated in our letter of April 3 with respect to the study and report generally, the total picture emerging from our studies is one of basically strong institutions subject to many specific weaknesses and abuses. The balance is, of course, different for different market institutions. In particular, the over-the-counter markets have received less systematic and thorough attention than exchange markets under existing regulatory measures and mechanisms and the need and opportunities for improvements are correspondingly greater, even allowing for inherent differences in the natures of the two types of markets.

The faults and defects disclosed in the study do not call for public alarm as to the basic integrity of the securities markets but neither do they permit of complacency. The weaknesses that have been found in trading practices and regulatory controls are of various kinds and perhaps varying degrees of seriousness, but in the opinion of the Special Study all of them call for attention and action—if not following the specific recommendations of the report on each matter, then seeking an alternative way of meeting the disclosed need—if our market institutions are to achieve and maintain a quality commensurate with their importance to the American economy and the American public.

The chapters transmitted with this letter, perhaps even more than others in the total report, deal with numerous matters of great complexity and difficulty, some of which have neither been the subject of continuous regulatory attention nor the subject of intensive studies in many years, if ever. The Special Study has arrived at its conclusions and recommendations after thorough analysis and thoughtful review of massive quantities of data and presents them with confidence and conviction as to their essential soundness. Nevertheless, it is recognized that many of them may be quite controversial, and that in some instances alternative solutions may be preferred after further exploration. It is pertinent to repeat here what we said in chapter I.A.5 (at pp. 7–8, of pt. 1) of the report:

> No part of the present report has been submitted in draft form, for comment or correction or any other purpose, to any of the private persons or groups referred to or potentially affected by the contents. Assuming that this would otherwise have been an appropriate course, it was an impossible one within the time limit of this study. Thus, such persons and groups have not had the opportunity to respond directly to any of the factual materials, analyses, or proposals contained in the report, as they undoubtedly would have been entitled to if the report amounted to a final disposition of any of the ques-

tions discussed. Since the report does not "decide" any question, but only expresses conclusions and recommendations of the Special Study, adequate opportunity for pointing out errors of fact or analysis or for disputing conclusions and recommendations will be afforded in the legislative hearings or administrative proceedings that necessarily will precede adoption of any recommendations to which there might be opposition.

* * *

Since the publication of the first group of chapters, a few errors contained in them have been brought to our attention. We most sincerely regret these errors and any confusion or embarrassment they may have caused. These are listed in an attachment to this letter.

* * *

In our transmittal letter of April 3, 1963, we identified the members of the staff of the Special Study and also referred to the invaluable assistance received from individuals and groups outside of the formal study staff. While the acknowledgments in our earlier letter apply generally to all chapters of the report including the present ones, it should be pointed out that the study received particularly important assistance in connection with the present chapters from the following individuals on the Commission's staff outside the study staff: Walter Werner, Gordon Henderson, Charles R. McCutcheon, Vito Natrella, John Woodward and Joel Rabin.

In the list of those outside the study's own staff who have borne added burdens in connection with the study and have greatly facilitated its work, there should have been included the names of Harry Pollack, director of personnel, and Albert Fontes, assistant director of personnel, as well as the staff of the Commission's Miami branch office. To the list of outside organizations rendering important assistance in data processing should be added the Computation Laboratory of the National Bureau of Standards and the Columbia University Computer Center. Additional persons serving on the clerical and stenographic staffs of the study included: Bernard H. Garil, Leola B. Kelley, Larry L. McKown, John F. Morris, Jr., Margaret L. Olearnick, H. Janice Purschwitz, Yvonne D. Scott, David L. Shriver, and Barbara J. Yokemick. Finally, our previous letter incorrectly listed one member of the regular staff, Fred Siesel, as a financial analyst instead of among the economists and statisticians.

Respectfully submitted.

MILTON H. COHEN,
Director,
RALPH S. SAUL,
Associate Director,
RICHARD H. PAUL,
Chief Counsel,
SIDNEY M. ROBBINS,
Chief Economist,
HERBERT G. SCHICK,
Assistant Director,
Special Study of Securities Markets.

ERRATA IN PARTS 1 AND 3 OF REPORT

At page 87 of part 1 of the printed report (ch. II.B.3) the following statement appears:

> The brokers blanket bond essentially covers losses resulting from dishonest or careless acts (theft, embezzlement, loss, or misplacement of property, etc.) but not from violations of Federal and State securities laws or from insolvency.

Since the report appeared, our attention has been drawn to two pertinent cases, one recently decided and the other still in litigation. In *The Home Indemnity Company* v. *Reynolds & Co.*, 187 N.E. 2d 274 (Ill. App. Ct. 1st D., 1962, reh. den. Jan. 31, 1963), the court held that a sale of securities in violation of the Illinois Securities Act was a criminal or dishonest act for which recovery could be had under a brokers blanket bond. In the second, *Atkin et al.* v. *Hill, Darlington & Grimm, et al.*, still pending in the New York courts, a broker-dealer takes the position that a bonding company is liable under a brokers blanket bond with respect to sales of insurance company securities in violation of section 51 of the New York Insurance Law.

At page 583 of part 1 of the printed report (ch. IV.E.3) a footnote lists Realty Equities Corp. of New York as one of five cash-flow real estate corporations having stocks listed on the American Stock Exchange. This company is not a cash-flow corporation and its name should be eliminated from the footnote. The text, accordingly, should refer to four rather than five such companies.

At page 54 of part 3 of the printed report (ch. IX.B.5.e) the following appears:

> * * * The broad conclusion of the study, which is in accord with the publicly expressed view of one of the most knowledgeable authorities covering over-the-counter markets, Wallace H. Fulton, the retiring executive director of the NASD,[1] is that section 16(b) should apply generally to unlisted securities.

The Special Study has been subsequently advised by Mr. Fulton that the above does not correctly reflect his position, since his expression concerning extension of section 16(b) to over-the-counter markets was subject to the qualification that it would be necessary to have an exemption "for a securities firm making a market in a security which has a partner or an officer serving on the Board of the company issuing that security."

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 6, 1963.

To the Chairman and Members of the Securities and Exchange Commission:

We have the honor to transmit herewith the final four chapters—X, XI, XII, and XIII—of the Report of the Special Study of Securities Markets. (In our transmittal letter of April 3, 1963, we referred to a possible chapter XIV to cover topics that might not fit within the scope of any of the other chapters or within the limits of later transmittal letters. It has not been found necessary to have a separate chapter XIV.)

[1] New York Times, Feb. 27, 1962, p. 51.

In our two previous transmittal letters, we have made some general comments about the nature of the study and of our findings. These were intended to apply to the entire report and we find no reason to modify them at this time. The following paragraphs from our letter of April 3 should have reemphasis as we complete the report:

> The enormous growth of the securities markets experienced since the original enactment of the Federal securities laws, reflecting both the vigor of the industry's own activities and the general expansion of the country's economy and population in the intervening years, has been accompanied by many qualitative changes in methods, practices, controls, and standards. A basic objective of the Special Study was an evaluation, in the light of both quantitative and qualitative changes, of the theories and mechanics of direct governmental regulation and industry self-regulation originally envisaged by those laws. The study and report indicate that under the stresses of its expanded role the framework of regulation needs considerable adjusting and strengthening, but its basic design appears to have stood the test of time and to have worked effectively in most areas.
>
> Since the Federal securities laws have been in force for a full generation. it is hardly surprising that the Special Study has not disclosed the prevalence of gross abuses such as were characteristic of the era which preceded their enactment. Nevertheless, as will be evident from the entire report, many serious problems do exist and important improvements are needed. It is inevitable that in reflecting the results of any investigation, a final report will give greatest attention to the problems uncovered and the areas in which the need for improvement is most pressing. Nevertheless, the emphasis in this report on present shortcomings should neither obscure nor detract from the many aspects of the securities business and its regulation and self-regulation which afford reason for pride and satisfaction. The strength of the American economy and its free-enterprise system both reflect and are dependent upon an investment banking system and market institutions that are basically strong and sound, but this makes it all the more, rather than less, necessary to expose and correct the weaknesses and abuses that still exist. Many of the substantive recommendations in the report can, indeed, be regarded as attempts to raise the entire securities industry to the best standards which the industry itself proclaims and to the highest levels of attainment which some of its participants have in some sectors achieved.

The chapters first transmitted (I to IV and IX) called for certain legislative solutions and these have been substantially embodied in S. 1642, recently passed by the Senate, and in the pending bills H.R. 6789 and 6793. The second group of chapters (V to VIII) essentially called for only one item of legislation—authority to regulate over-the-counter quotations systems. As to the present group of chapters: Chapter X, dealing with security credit, would require statutory changes if the Federal Reserve Board and the Commission subscribe to certain of our substantive recommendations. Chapter XI, relating to mutual funds, would call for a legislative solution in respect of so-called contractual plans, but in this instance we have assumed that the formulation of a legislative program will await completion of the Commission's other pending studies regarding structural aspects of mutual funds. With regard to chapter XII, dealing with the self-regulatory and regulatory pattern, various statutory changes would unquestionably contribute to a more complete and logical pattern of relationships between the Commission and the various self-regulatory agencies and at the same time might be the most direct means of resolving issues presented by the case of *Silver* v. *New York Stock Exchange*. On the other hand, we are not prepared to say, in the absence of a more detailed legal analysis than we have been able to make, that the Commission's present broad

statutory powers would not be adequate for all purposes indicated in the chapter, and accordingly we make no specific legislative recommendation in this area. Chapter XIII, relating to the 1962 market break, likewise does not contain any recommendation for legislation.

It should be emphasized, in any event, that any questions of legislation arising out of the present group of chapters are quite separate from the matters covered in our prior legislative recommendations as embodied in the bills now pending, i.e., qualifications for entry into the securities business and disclosures for over-the-counter securities. Nothing in our later studies or analyses has in the slightest degree shaken our conviction that the latter subjects of legislation are basic and urgent, both in their own right and as foundations for other improvements in rules and practices in the securities markets.

The legislative recommendations of the total report are relatively few, not because there is little to be done, but because most of what we recommend can in all likelihood be accomplished under existing powers of the Commission and the self-regulatory agencies. The total report constitutes not only a comprehensive factual presentation but also a major agenda for action by the Commission and the industry groups to correct the shortcomings in the market and regulatory mechanisms that have been disclosed.

* * *

In our prior transmittal letters we expressed appreciation for the contributions of the groups and individuals, within and outside the Special Study staff, who have importantly contributed to the work of the Special Study. Without repeating their names, we again express appreciation for the loyal and devoted efforts of the very competent group who served directly on the study staff and for the indispensable assistance and cooperation received from others, including the members of the Commission, members of the staff of other divisions, other governmental and private agencies, and, by no means least, individuals and firms in the securities business and their self-regulatory institutions. Our previous letter neglected to mention the valuable assistance received from Joseph A. Keenan, Jr., of the Division of Trading and Exchanges.

Our previous letter incorrectly listed Bernard H. Garil as a member of the clerical staff rather than as a financial analyst, and omitted mention of Gerald L. Feigen, who served on the study's staff as a financial analyst.

Having been stationed at the Commission's office facilities at its headquarters in Washington, we cannot refrain from commenting on these facilities. The Commission is a permanent, important agency of the U.S. Government, in existence since 1934, yet it still has its headquarters in a "temporary" building and annexes whose many inadequacies, inconveniences, and discomforts cannot but impair the efficiency of its operation and even hamper its efforts to recruit and retain needed personnel. In the name of good government, the Commission urgently needs a more businesslike office where its personnel may do their work efficiently, comfortably, and pridefully.

* * *

As the Special Study leaves the scene, others must assume the large responsibility of converting recommendations into programs of action. In the long run we are confident that the information,

analyses, and recommendations that have been produced by the Special Study will improve the operation of the securities markets, produce a healthier securities business, and provide stronger safeguards for the investors of the Nation.

Respectfully submitted.

Milton H. Cohen,
Director,
Ralph S. Saul,
Associate Director,
Richard H. Paul,
Chief Counsel,
Sidney M. Robbins,
Chief Economist,
Herbert G. Schick,
Assistant Director,
Special Study of Securities Markets.

SUMMARIES, CONCLUSIONS, AND RECOMMENDATIONS

CHAPTER I

INTRODUCTION

[This chapter describes the background of the Special Study and sets forth statistical data concerning the securities industry.]

CHAPTER II

QUALIFICATIONS OF PERSONS IN THE SECURITIES INDUSTRY

The large numbers of new investors and new broker-dealer firms and salesmen attracted to the securities industry in recent years have combined to create a problem of major dimensions. Among the new investors have been the naive, the unsophisticated, and those with slender resources, while the new broker-dealers and salesmen have included persons who were inept, ignorant, or rapacious. The protection of the former from the errors and depredations of the latter has imposed a heavy burden on the governmental and self-regulatory agencies charged with the protection of the public interest in the area of securities and securities markets.

More than a generation of experience with the Federal securities laws has demonstrated, moreover, that it is impossible to regulate effectively the conduct of those in the securities industry, unless would-be members are adequately screened at the point of entry. Neither the industry nor the Government nor the investing public can afford the burden of a policeman on every corner. The steady growth in the very numbers of investors and participants has made obsolete the concept that entry into the industry should be the right of anyone, regardless of fitness or capability, except those guilty of recent securities violations. The right to carry on those functions of the industry which involve the public investor should be available only to those who shall have demonstrated their ability to meet at least minimal standards of integrity, competence, and financial responsibility.

1. THE REGULATORY STRUCTURE

The agencies with jurisdiction over members of the securities industry, and which are therefore in a position to determine who may enter, include the Commission, the National Association of Securities Dealers, Inc., the various stock exchanges, and the securities administrators of the several States. The present restrictions upon entry into the business that are established by this polycentric system of controls form, as might be expected, an unfortunately irregular and erratic pattern, involving both considerable overlapping of effort and serious deficiencies in total result. No national securities exchange that may wish to set higher standards for its membership should be discouraged from doing so, but there should be a rise in the minimum level of standards applicable to all firms and persons in the securities business.

The Commission's controls which affect the largest number of persons in the industry—though even its jurisdiction does not embrace all elements—constitute the lowest barrier, excluding only those

individuals whose previous unreliability in matters of securities has been evidenced by judicial or Commission decision. All other persons are admitted upon their firm's registration, without regard to their character, competence, or original capital commitment. The NASD also has jurisdiction over a wide segment of the securities industry. It has until recently required little more than the Commission. While banning from membership or employment by members roughly the same categories for which the Commission denies registration, the NASD delegates questions of prospective registered representatives' character to the discretion of member firm employers and until 1962 gave a spurious accreditation of competence through a now-discarded examination. The examination which it adopted, and a more recent extension of its examination program to include proprietors, reveals an effort to raise standards in the area of competence. Yet it remains true that the authorities exerting controls over the broadest range of the diverse activities of the securities business—the Commission and the NASD—accomplish little toward excluding undesirable and unqualified persons. Higher standards of character, competence, and capital requirements are imposed by the major exchanges, and particularly the New York Stock Exchange, but the selective nature of exchange membership limits the number of industry members under their control. The States vary widely in the scope of their statutes and regulations and in the vigor with which these provisions are enforced; at best they are handicapped by geographic limitations in dealing with what is essentially a national problem.

Since NASD membership is based on specific economic inducements, there are gaps in its coverage which leave important categories of securities firms—certain mutual fund distributors, and real estate syndication broker-dealers, put-and-call dealers and registered investment advisers, for example—subject only to Commission controls over the qualifications of their principals and employees. In a qualification system which envisages the complementary efforts of governmental and industry regulatory agencies, all groups subject to governmental controls ought also to be subject to industry controls, either through the existing NASD or through other self-regulatory organizations with similar functions and status.

Customers of any firm subject to Federal jurisdiction should be able to assume that the firm's principals, the salesmen with whom they deal, the salesmen's supervisors, and the persons responsible for the investment advice upon which they rely, have met at least minimal standards of competence and integrity and have at least a minimal commitment to their business. In the light of the findings of the Special Study, such an assumption has less validity than should be the case. National securities exchanges should not be discouraged from erecting higher standards for any categories of persons they deem appropriate, but it is up to the concerted efforts of the Commission and the NASD to determine, establish and administer the minimum standards for all firms and persons.

In establishing minimum standards, the various lists of so-called statutory disqualifications, which now apply only to misbehavior relating to securities, should be expanded and made uniformly applicable to all categories of principals and employees. Not every activity which results in the imposition of penal sanctions should dis-

qualify a person from the securities business, but the public is no less concerned with records of theft, fraud, embezzlement, or similar crimes on the part of the salesmen or broker-dealers with whom they deal simply because they involve property other than securities. Particularly important in implementing the establishment of minimum standards, as well as for other regulatory purposes, is the revision of broker-dealer registration forms to require the filing of further information concerning the nature and scope of a firm's business and concerning some categories of its personnel for whom minimum standards must be established, but about whom the regulatory agencies now have no readily accessible information.

2. BROKER-DEALERS

The ease with which almost anyone can start his own securities firm and deal with the public has permitted many an amateur to embark on the deep waters of broker-dealer entrepreneurship. The statistics and cases reviewed in this chapter indicate a surprisingly high incidence of inexperience in the securities business on the part of principals of new firms, and concurrently a lack of awareness of and respect for a broker-dealer's obligations to the investing public. They suggest also that the initial capital commitment of a large number of the new firms is nominal or at best unduly modest. Many of these firms quickly become sources of concern to the Commission and the NASD; the Special Study's analyses and observations revealed a distinct tendency on the part of newcomers to become involved in the more serious securities violations more often than experienced firms. New firms often have particular difficulty in maintaining adequate records and complying with the Commission's net capital ratio requirement. Many new firms include among their salesmen "boiler-room" veterans or totally inexperienced newcomers, or both. The training which such firms give their inexperienced salesmen rarely goes beyond a modicum of orientation to the firm and a brief introduction to its merchandise.

The potential of harm to the public from a firm whose principals are unqualified is intensified when, as so often happens, the firm engages in underwriting. This activity generally calls for skills and involves responsibilities beyond those required for an ordinary brokerage business. The study's review of underwriting practices [1] reveals a disquieting tendency for firms with the least experience and least capital to engage in underwriting the most speculative and questionable new issues.

A minimum net capital requirement for broker-dealers, with appropriate flexibility to meet the variety of functions—from the underwriter to the very small mutual fund distributor—although not foolproof or sufficient in itself, would substantially add to both responsibility and commitment without imposing an incommensurate burden. The securities business involves dealing in other people's funds and liquid assets; the regulatory scheme is based to a significant extent on the sanction of legal liability to customers for improper conduct; the smooth and speedy functioning of market mechanisms depends on mutual confidence among members of the financial com-

[1] In addition to the discussion in ch. II.B, see also ch. IV.B (pt. 1).

munity in each other's stability and responsibility—for these and other reasons, a minimum net capital provision should be deemed an essential qualification for any broker-dealer entering the securities business.

The obligations, duties, and responsibilities of the proprietor go well beyond those of a salesman, and an individual who assumes them should be expected to meet correspondingly higher qualification standards. In the past, no more has been required of an inexperienced principal of a firm applying for NASD membership than that he be free of statutory bars and that he pass the same examination given for registered representatives. The NASD is to be commended on its recent steps towards requiring special examinations for inexperienced broker-dealer principals, as is the NYSE for its recently instituted examinations for members and allied members; but however effective experience proves these examinations to be as tests of knowledge, they cannot adequately substitute for experience or evaluate good character. Although the NYSE and some other exchanges now require an apprenticeship training period for floor members and members who deal with the public, and also investigate the backgrounds of all principals of member firms, the NASD still has no rules requiring minimum experience and makes no investigation of principals of prospective members except to check for the existence of statutory disqualifications. Furthermore, foreclosed by the 1942 Commission decision, the NASD has no requirement of a minimum capital commitment to the business.

If the public is to be protected from the perils of incompetent and irresponsible broker-dealers, there should be erected uniform, minimum standards of competence, experience, character, and capital which are applicable to the entire securities industry.

3. SALESMEN

The qualifications of salesmen, who more than any other group represent the securities industry to the investing public, require particular attention. Out of the recent rapid growth and heavy turnover of salesmen have arisen two types of problems for the industry: the large number of inexperienced salesmen it has attempted to absorb, and the reservoir of "boiler-room floaters" who circulate from firm to firm.

The growth of the securities industry has forced it to recruit inexperienced sales personnel in large numbers. About 25 percent of all registered representatives employed by NASD member firms as of the end of 1960 had less than a year's experience; for 1961 the percentage was 29, and for 1962 it was about 15 percent. Among firms specializing in mutual fund sales, inexperience is often preferred. This mass of inexperienced salesmen encompasses the broadest range of educational achievement, from those with graduate degrees to those without high school diplomas, and the greatest diversity of backgrounds, from a number with business, supervisory, selling, or professional histories to persons with such occupations as machinist, chef, or baseball player. While approximately half of the incoming salesmen have chosen to work part time, the Special Study has found no evidence which shows a causal link between part-time work as such and a peculiarly high degree of insufficient training or inexperience.

The "floater" represents a problem of an entirely different kind. Because of the brief lifespan of most "boiler-rooms" and the large numbers of salesmen they typically use, there exists a fairly sizable group of alumni of these organizations, forming a reservoir of high-pressure salesmen available for employment. While not every salesman who has been employed by a firm involved in disciplinary proceedings with the Commission or the NASD should be barred from future employment as a securities salesman, many floaters actively and willingly participated in the unethical selling practices of their prior employers and are still available for employment in the industry only because administrative considerations, such as limitations of time, budget, or manpower, prevented the Commission or the NASD from naming them as causes in the proceedings.[2] These floaters carry the virus of high-pressure salesmanship from firm to firm, and find inexperienced proprietors and salesmen—often well intentioned—particularly vulnerable to infection with their irresponsible selling practices.

It would be comforting to believe that qualification deficiencies are limited to floaters, and that no other securities salesmen are turned loose to sell their intricate merchandise to the investing public until the firms concerned have checked carefully into their backgrounds and also trained them properly to carry out their functions. The findings of the study indicate that for many salesmen, the employing firm has not discharged these responsibilities.

The ultimate responsibility for the quality of salesmen must lie in the firms which employ them and which share with the public an interest in having salesmen of good character and thorough training. An unhappily large segment of the broker-dealer community scores poorly in this respect. Some firms do conduct considerable investigation of the backgrounds of prospective sales employees, and carry on extensive and generally effective training programs, sometimes including their own classroom programs. Far more firms, however, take a more casual view of their responsibility. The more typical firm does little to investigate the background of a prospective salesman other than writing or telephoning to his previous employer or employers, which it regards as the only step necessary to comply with the NASD requirement of certification of good character. For any further investigation, it merely relies on an exchange, if it is a member, or on its bonding company, if through choice or regulatory requirement it uses one.

As to training, there is a wide range of practices between the best, exemplified by the few firms referred to above, and the worst, or no training at all. For the most part the best training is found among the larger, more prosperous New York Stock Exchange firms, whose programs to some extent reflect the influence of the Exchange requirement that inexperienced prospective salesmen (other than limited registrants) receive 6 months of training before being permitted to sell. Much of the industry relies upon on-the-job training, which may mean that trainees perform tasks reasonably calculated to give them useful experience in the firm's operations, or may on the other hand mean no more than that new men

[2] See ch. III.B.6.b (1) and (2) (pt. 1), concerning Commission and NASD controls over selling practices.

sit around watching the old hands sell. Encouraging developments are the increased reliance of many firms, whose own resources are too limited for successful training, upon courses given by outside institutions and the training materials which the NYSE has recently published. All too frequently, however, a firm regards its training program as a stepchild, made necessary by exchange training requirements or the importance of having trainees pass an examination, and to be supplied on a minimal basis.

The self-regulatory agencies for the most part take a neutral attitude toward training programs. Apart from the Philadelphia-Baltimore-Washington Exchange, which uses a review of firm training programs rather than an examination to determine the qualifications of new salesmen, the usual approach is to encourage the use of organized training programs, and even, in the case of the NYSE, to provide advice concerning them, but to set no minimum standards for them (other than the NYSE and Amex requirements of 6 months' duration), and neither to approve nor disapprove any particular programs.

The basic instrument for assuring the public that a salesman has a reasonable minimum of competence has been, and must continue to be, the examination. The examination instituted by the NASD in January 1962 represents a considerable advance over its old memory test, which had proved almost completely ineffective in accomplishing its screening purpose. The new NYSE examination also represents an improvement over its predecessor, which had imposed but a minor obstacle to the neophyte salesman's entry into the exchange community. On the whole, the self-regulatory agencies have shown increasing concern for salesmen's competence. They should amplify their efforts to encourage the spread of the best practices already employed by some of the firms, and should insure that no firm uses practices falling below the minimum necessary to protect investors.

Assuring the public of the integrity of salesmen presents a problem as important as that of competence, but far more difficult. The NYSE, and to a lesser extent some of the other exchanges, conduct independent investigations of the backgrounds of prospective salesmen for member firms. For the most part their system appears well geared to eliminating salesmen with undesirable prior activities and associations, though occasional employment of salesmen with extensive "boiler-room" backgrounds still occurs. The NASD is faced with a far more formidable task in terms of numbers alone: almost 30,000 inexperienced salesmen joined NASD member firms in 1961, while new registered representatives were being trained by NYSE member firms at the rate of 5,000 a year in the spring of 1962. The NASD has considered that responsibility for the integrity of its members' salesmen is a matter for determination and certification by its members, and its members have frequently viewed that responsibility as requiring no more than a contact with the salesman's last employer. While improper certification by a member may constitute cause for disciplinary action, the delegation of responsibility to member firm principals who themselves are subject to little control in this respect means that for the salesmen of many NASD members, character controls are no more than a fiction or a facade. Yet if the goal of qualifying salesmen in the area of character and integrity is

to have any chance of realization it should be brought about through an organization like the NASD, which is national in jurisdiction but local in its activities and personnel.

The principal external controls over the qualifications of salesmen imposed by the Commission and the NASD operate indirectly through the unit of the broker-dealer firm which employs them. The result is an irregular pattern of standards unevenly imposed and awkward in their administration. The Commission, charged with the duty of excluding from the industry all broker-dealer firms employing salesmen subject to statutory bars, does not even have a record of the salesmen employed by the firms which it registers. Furthermore, its administrative procedures for eliminating undesirable salesmen, either before or after they have been hired, must be directed not at the objectionable salesman himself, but at the employing firm—regardless of its involvement or noninvolvement in the objectionable activities of the salesman in question, and regardless of its general record. This can place the Commission in the unfortunate dilemma of having to bring a proceeding against the employing firm in order to discipline a salesman who has been guilty of improper practices, or else ignoring the improprieties altogether. Even though the NASD does maintain records of salesmen employed by its members, it is in a similarly awkward position when it comes to excluding or eliminating undesirable salesmen. In addition, the fact that the economic inducements to NASD membership have not drawn all broker-dealers into that association means that salesmen of some employers are not even subject to NASD controls over salesmen's qualifications.

The establishment of a national system of direct licensing of securities salesmen would eliminate the present lack of uniformity in qualification standards and would allow disciplinary proceedings to be brought against individual salesmen. It would have the additional advantages of eliminating some of the present duplication and of imposing on each salesman a direct individual responsibility for his activities. Such a uniform national system must contemplate the coverage of salesmen for all elements of the securities industry through the NASD and other industry self-regulatory institutions. In any such system, a determination of qualifications of both competence and character should be made by the self-regulatory industry organizations, which can administer industrywide standards of competence and make individual determinations in the difficult matter of salesmen's integrity. After being issued a license, a salesman would be eligible for employment by any broker-dealer firm without any need for reregistration. His competence would be determined through an appropriate examination, and his good character through investigation, and in doubtful cases, through personal interviews by local committees or boards. The individual firm would be permitted to employ only licensed personnel but would of course be free to apply its own additional criteria or those of any exchange of which it was a member.

Any licensing program should recognize, to an extent not found at present, the different competence needs of salesmen of different kinds of securities. Mutual fund industry representatives assert that much of the knowledge of the operations of the securities markets which is essential for the registered representative who sells listed and most

over-the-counter securities is unnecessary for the mutual fund salesman, who may, on the other hand, need greater training in areas relatively unimportant to the general securities salesman. Some of the exchanges appear essentially to agree, and have established various programs leading to a status of limited registration mainly for those who sell mutual funds. Other selling specialties, such as the sale of real estate syndication interests, present the same situation. It should be possible to establish a licensing system permitting a person to sell a particular type of security upon demonstration of his competence to sell it, but at the same time limiting his activities to that type of security. Under such a system a salesman trained, for example, in the mutual fund field could take an examination appropriate to that field, but would not be free to sell securities of any other kind.

4. SUPERVISORS

The growth of the securities industry and the number of securities salesmen and branch offices has compounded the problems involved in the supervision of salesmen's activities and has magnified the importance of the person engaged in such supervision, whether he be a principal or employee of his firm. Industry members have increasingly recognized the significance of supervisors and the importance of their responsibilities, and the NYSE notes that "the branch office manager undoubtedly holds one of the most important jobs in the securities business." Nevertheless, many instances have come to the attention of the study of persons acting as supervisors or managers who were unqualified for their responsibilities. There is almost universal industry emphasis on supervisors' production but much less emphasis upon such factors as their experience or their knowledge of the securities business, the applicable laws and rules, and supervisory or other office procedures.

At the heart of the problem of supervisors' qualifications lies the industry's reluctance to recognize that persons in this capacity serve functions distinct and different from the roles played by those whom they supervise. Awareness of this fact has, however, recently been expressed by the principal self-regulatory organizations. Since the study began its work, both the NASD and the NYSE have instituted or taken steps to institute separate examinations for those who, because of their proprietary interests in their firms, will have supervisory responsibilities. While these examination programs do not at present cover employee-supervisors, both the NYSE and the NASD have indicated that they are contemplating such a step. The NYSE has also announced that it is applying substantially higher experience requirements than it heretofore used in granting approval of branch managers.

Separate qualification standards and separate licensing of supervisors on an industrywide basis is of first importance in raising industry standards generally. Furthermore, in order that the Commission may determine the extent of compliance with such standards, it should receive, as part of a broker-dealer's registration, information concerning the names and histories of all persons having supervisory responsibilities, and not just proprietors as at present. There should also be clear identification of the individual in the home office of each firm who is responsible for regulatory and self-regulatory

matters, so that responsibility for activities affecting the public interest will be lodged in a single individual.

5. PERSONS PROVIDING INVESTMENT ADVICE

Qualification standards for persons, other than salesmen as such, who are responsible for disseminating investment advice, whether through broker-dealers or through registered investment advisory or investment counsel firms, are nonexistent beyond the negative standard of the disqualifying statutory bars. Neither the Federal Government nor any self-regulatory body exercises any controls over the competence of these persons for the performance of their advisory work. This lack of controls results in an anomalous situation. An individual in a broker-dealer's research department, charged with the responsibility of selecting the securities for his firm to recommend to its customers, is required to meet no qualification standards. The salesman, on the other hand, whose role may be limited to transmitting such research recommendations to the customers, must pass examinations which test, among various subjects, his ability to analyze securities. Furthermore, the proprietors of registered investment advisers who confine their activities to the giving of investment advice need not pass any examination at all, except in a few States, even though they may be responsible for advising individual clients or subscribers to their publications to engage in particular securities transactions.

While there is no need to impose qualification standards on every person employed by a registered broker-dealer or investment adviser to perform services as a researcher or analyst or statistician, minimal standards of competence or experience should be applied to each person who is responsible for actually transmitting unsupervised investment recommendations to the public, whether directly or through registered representatives. The self-regulatory organizations should assume the responsibility for determining and imposing such standards for persons employed by broker-dealer firms subject to their jurisdiction. Membership in an effective self-regulatory agency should be required for all investment advisers now or hereafter registered with the Commission, and the agency should assume responsibility for determining and imposing minimum standards for principals and appropriate categories of employees of registered investment adviser firms. Information concerning the names and histories of the persons covered by such qualification requirements should be included in the material which broker-dealers and investment advisers supply to the Commission as part of their applications for registration.

The Special Study concludes and recommends:

1. Under a regulatory scheme relying heavily on self-regulation, it is anomalous that some broker-dealers or investment advisers should remain outside of any official self-regulatory group so that their activities are subject only to direct regulation by the Commission. Membership in an appropriate self-regulatory group (exchange or national securities association or affiliate thereof) should therefore be a prerequisite to registration as a broker-dealer or investment adviser. If it should not prove feasible to

establish a program of compulsory membership in a self-regulatory body for all broker-dealers and investment advisers subject to Commission jurisdiction, the added cost of governmental supervision should be passed on and directly borne by those in the industry who are not members of such a body, through fees or other assessments.

2. At present the only requirement for Federal registration as a broker-dealer or investment adviser is that the firm and its principals have not previously misbehaved in specified ways, and there is a separate list of statutory disqualifications for NASD membership. These statutory disqualifications should be combined and made applicable to all broker-dealer and investment adviser firms and certain categories of individuals in the securities business, such as principals, supervisors, and salesmen. There should be added to the combined list conviction within 10 years of crimes (a) involving theft, fraud, embezzlement, defalcation, or criminal breach of fiduciary duty, or (b) arising out of the conduct of the business of a broker or dealer or investment adviser.

3. The Commission's present registration forms for broker-dealers and registered investment advisers fail to supply essential information for determining initial qualifications and for continuous regulatory needs. Every broker-dealer firm should be required to furnish initially, and keep current through annual or other periodic reports, information concerning (a) major activities engaged in or to be engaged in; (b) exchange and NASD memberships; (c) number and location of branch offices; (d) clearing firms, correspondent firms, and wire connections; (e) size and composition of sales staff; (f) size and composition of any research department; (g) the individual in responsible charge of regulatory and self-regulatory matters within the firm, the supervisor of each major department of function (underwriting, retailing, research, trading, back office, etc.); the manager or supervisor of each branch office, and each individual authorized to handle discretionary accounts; and (h) the prior experience of any such individual, supervisor, or manager. Every registered investment adviser should be required to supply and keep current information concerning (a) major activities to be engaged in; (b) research techniques used and/or other bases of recommendations; (c) size and composition of any research department; (d) the individual in responsible charge of any such research department, and/or in responsible charge of the firm's investment recommendations; and (e) the prior experience of any such individual.

4. The individual rather than the firm is the appropriate "unit" for many regulatory purposes, in the interest of fairness as well as efficiency. The present statutory registration scheme does not reach individuals at all, and the self-regulatory concept of "registered representatives" of particular firms does so only partially and indirectly. Without limiting the responsibility of firms for the personnel they employ or the right of firms to select their own employees, there should be established a system of licensing and registering individual salesmen, supervisors, and other specified categories of personnel. Each such individual should be required to file a single basic registration form containing necessary