companies newly listing securities to publish quarterly statements of earnings as well. The New York Stock Exchange also requires listed companies to solicit proxies for all meetings of shareholders. The American Stock Exchange is in the process of extending the same requirement to all of its issuers of listed issues. Certain of the regional exchanges provide the same or similar protections.

By contrast, comparable protections in the over-the-counter market are provided for only limited classes of securities and, for some of those, only in part. A vast number of issuers of over-the-counter securities are not required to file reports or to furnish their shareholders with adequate information when proxies are solicited, nor are they subject to insider-trading controls. A limited number of issuers are subject to reporting requirements only, by reason of a prior public offering, and a limited number are required to supply shareholders with annual financial statements in order to have securities eligible for the retail quotation lists of the NASD, but even these partial protections apply to securities comprising only a small part of the over-the-counter market. Viewed as a whole, that market presents a striking regulatory disparity with exchange markets.

The disparity and the need to eliminate it have long been recognized. When Federal securities laws were first enacted, Congress itself expressly provided for "comparable protection" and various studies since then, which the Special Study has confirmed, have demonstrated the need. Legislation to accomplish the desired end has been proposed in the past, but has failed of adoption at least in part because of unresolved questions as to its scope of coverage. Indeed, the open questions in this area cannot be questions of principle as to whether or not the protections are desirable, but only questions of where lines should be drawn in the light of practicalities.

The Special Study attempted to assemble data that would be helpful in determining the scope of remedial legislation. It is established law that an offering may be "public" for purposes of the registration requirements of the Securities Act, whatever the number of persons involved, if the circumstances are such that the protections afforded by registration are needed. By parallel reasoning, if securities are already traded in public markets, the protections of sections 13, 14, and 16 theoretically should not depend on the size of the issuer or the number of its security holders. Nevertheless, practicalities of administration made it advisable to seek data bearing on the number of companies that would be affected by various coverage criteria and some of the characteristics of those that might be included and excluded.

A comprehensive survey of issuers of over-the-counter stocks—more comprehensive than any before attempted—leads to the conclusion that a number-of-shareholders criterion of coverage (the kind of standard principally adopted in prior legislative proposals) is both most theoretically sound and most workable. Comparisons of corporate characteristics and numbers of shareholders of the corresponding issuers show that a clear relationship exists between shareholder size and the apparent degree of trading activity indicated by numbers of transfers of record and frequency of broker-dealer quotations. Little, if any, relationship between either of the foregoing and asset size is apparent. In the light of the detailed data set forth, including estimates of the total number of companies affected, a coverage stand-

ard of 300 shareholders is indicated. Administrative needs, however, suggest a phased program of reaching that standard gradually by at first adopting a higher figure and progressively lowering it as administrative means are made available.

The potential impact of section 16(b), the insider-trading provision, on broker-dealers who both maintain dealer markets in securities and sit on the corresponding corporate boards of directors appears to have been greatly exaggerated. Only a small segment of all over-the-counter issues are involved; many broker-dealers, if faced with the choice of resigning as director or abandoning a trading market, would doubtless choose to resign rather than cease trading; and except in a very rare case it is difficult to conceive of any individual's indispensability as both director and market maker. Nevertheless, if such indispensability can be affirmatively shown, the Commission should be empowered to grant exemption from section 16(b). A general exemption for marketmaking transactions would be unwarranted.

Over-the-counter securities which are made subject to sections 13, 14, and 16 will be a special and distinct segment of over-the-counter securities for many regulatory and business purposes. To distinguish them appropriately, a designation such as "OTC listed" should be officially recognized. Issuers not subject to mandatory compliance with sections 13, 14, and 16 should be permitted to have their securities "OTC listed" by electing to comply.

Apart from extending existing protections for listed securities to over-the-counter securities, improving the existing protections in certain respects and wider dissemination of officially filed information would be desirable in any event.

The Special Study concludes and recommends:

1. Sections 13, 14, and 16 of the Exchange Act should be extended to issuers of unlisted securities, in the first instance to all issuers having 750 or more equity security holders of record and/or known beneficial holders, and, thereafter as rapidly as feasible to all issuers having 300 or more such holders, subject to the exemptions and exemptive powers recommended below. An issuer once subject to sections 13, 14, and 16 should continue to be so despite the fact that its number of equity security holders falls below 300 from time to time and should be relieved of compliance only after that number falls to and has remained at or below 200 for (say) 2 years, and thereafter only so long as the number remains below 300.

2. Section 15(d) of the Exchange Act is based on the principle that an issuer entering the public markets for capital should undertake continuing obligations to investors in those markets, if the amount of the issue (plus other securities of the same class) is at least $2 million. Under the recommendation made above to extend sections 13, 14, and 16 to all over-the-counter issuers that have 300 equity security holders a different and more embracing practical standard will become applicable, whether or not the issuer undertakes a new public offering. Since a phased approach to the ultimate coverage recommended is proposed on purely practical grounds, however, and since it does not appear to be impractical immediately to apply the ultimate standard to all issuers hereafter making a public offering, section 15(d) should

be amended to apply the protections of Sections 13, 14, and 16 to every issuer making a public offering and thereafter having 300 or more equity security holders. Issuers of future regulation A issues should be similarly provided for by appropriate amendment of the applicable regulations.

3. Since extension of sections 13, 14, and 16 to over-the-counter issuers will make their securities prima facie eligible for unlisted exchange trading privileges under section 12(f)(3) and it would be better to leave determination of the principal market in which an issue is traded to competition among markets and issuers' preferences, section 12(f)(3) of the Exchange Act should be concurrently repealed. Rule 12f–4, which exempts from sections 13, 14, and 16 issuers of issues granted unlisted trading privileges pursuant to section 12(f)(1), should be amended so that the exemption will be available only where the number of shareholders is less than the prevailing criterion for over-the-counter securities.

4. In principle, the recommended legislation should not exempt any category of issuers merely because they file reports or are otherwise regulated under other laws, unless such reports or other regulations are clearly designed for the protection of investors (as distinguished from consumers, policyholders, depositors or other categories) and do in fact provide protections reasonably equivalent to those of the Exchange Act. The legislation should expressly exempt only securities already defined as "exempted securities" by section 3(a)(12) of the Exchange Act (essentially Federal, State, and municipal securities) and securities of nonprofit organizations, but the discretionary exemptive power granted to the Commission by section 3(a)(12) should be available to enable it to exempt other categories upon a finding that their inclusion is not required in the public interest or for the protection of investors. The Commission should, as is now the case with respect to listed securities, permit any issuer filing data with any other Federal or State regulatory agency reasonably comparable to those required under section 13, to file copies of such data in lieu of data otherwise required under section 13.

5. There is no need for a general and broad exemption from section 16(b) requirements (relating to "insider" trading) in respect of broker-dealers making markets in securities of issuers on whose boards of directors they are represented. Entirely apart from the merits of broker-dealers' services on corporate boards generally, the combination of making a market in an issue (as "sponsor" or otherwise) and representation on the board of the issuer appears to be in most, if not all, circumstances an unnecessary one; and when consideration is given to the potential conflicts of interest inherent in the combination,[1] the balance clearly does not lie in favor of a general and broad exemption. To provide for any truly exceptional circumstances or instances (possibly, e.g., for a limited period of time after a first public offering and/or in the case of geographically restricted markets) the Commission should be empowered to provide limited exemptions on an affirmative showing both of unique need of the issuer or class of issuers and necessity and appropriateness in the public interest and for the protection of investors.

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[1] See ch. III.F. (pt. 1).

6. Since it is contemplated that some issues of securities in over-the-counter markets will, and others will not, be required to comply with sections 13, 14, and 16, the distinction will and should become a highly important one for many purposes; see, for example, paragraph 5 of conclusions and recommendations under chapter III.B., paragraph 1 under chapter IV.F., and conclusions and recommendations under chapters VII and X. The term "OTC listed" is suggested as a distinguishing hallmark for any over-the-counter security the issuer of which is required to comply with sections 13, 14, and 16. The legislation should expressly permit any other issuer to elect to comply, and thereby to bring its securities within the "OTC-listed" category.

7. Both in their present application to exchange-listed securities and in their proposed application to "OTC-listed" securities, sections 13, 14, and 16 or the regulations thereunder should be amended to provide improved protections in certain particulars: (a) Except in extraordinary circumstances, to be defined, financial statements included in reports to stockholders accompanying or preceding proxy solicitations should be required to be prepared and presented on substantially the same basis as the financial statements in officially filed reports; (b) appropriate rules with respect to broker-dealer transmission of proxy-soliciting material should be adopted by the NASD and section 14(b) of the Exchange Act should be amended to empower the Commission both to compel the giving and to control the manner of giving proxies on customers' securities, both listed and unlisted; (c) section 16(b) should be amended to permit recovery of short-swing profits of a broker-dealer firm where one of the principals is a director, "reversing" *Blau* v. *Lehman*.

8. If disclosure of information is fundamental in Federal securities regulation, the widest possible dissemination and use of filed information will obviously best serve the purposes of disclosure. In light of modern techniques for duplicating and communicating the printed word, it would seem that dissemination and not mere filing should be required in many instances. For example, just as there are now unofficial services that regularly distribute summaries of data concerning individual securities, it would seem feasible to require officially filed information to be presented in form for inexpensive duplication and distribution. It would also seem possible to require that copies be filed in appropriate Commission or NASD offices and/or that broker-dealers making markets or recommending purchases have copies on file or actually distribute them to customers in stated circumstances. The technical and economic feasibility of such measures and the advances in investor protection that they would make possible should receive immediate and continuing study by the Commission and the self-regulatory agencies.

C. Corporate Publicity and Public Relations

Planned publicity or "public relations" is a conspicuous feature of the American scene and, not surprisingly, its protagonists include many publicly held companies. The Special Study has concerned

itself only with its impact on the securities markets and public investors.

Public relations activities can act as a valuable supplement to the disclosures required by the securities acts, for presumably the highest form of full disclosure—"truth in securities"—is that which not only reaches but is understood by the widest public. During recent years, more and more corporations have begun to provide their stockholders with adequate periodic financial reports and to make prompt public disclosure of important corporate developments. But at the other end of the spectrum, where publicity perverts the concept of full disclosure, where the purpose or effect is manipulative, the impact of public relations becomes a matter of concern.

Although many companies and their financial public relations firms—publicists who specialize in communicating between issuers on the one hand and the financial press, the investment community, and stockholders on the other—conduct their activities with restraint and propriety, nevertheless a segment of this industry has been involved in the dissemination of inaccurate and misleading information. Even for companies subject to full reporting requirements, there are opportunities for fanciful publicity in the intervals between official reports, or by drowning out low-decibel reports through modern high-decibel publicity techniques. For companies outside the reach of official reporting requirements, uncontrolled publicity may be the only source of information or misinformation available to public investors and the investment advisers and broker-dealers upon whom they rely, and the opportunities and dangers are particularly great.

The intensive examination by the Special Study of the public relations activities of a few publicly held corporations demonstrates the potential impact of corporate publicity. Given a generally bullish market or existing public interest in a particular company or industry, a well-planned publicity campaign can have an immediate and dramatic effect on the price of a security. Examples were found in which a single carefully "placed" article had the effect, within a few days, of trebling the price of a stock with a thin floating supply. The business editor of a national publication for several years made a practice of purchasing the stock of small companies which the publication was about to write up, and selling his holdings shortly after the article appeared, usually at a considerable profit.

The purposes of issuers or their public relations men in disseminating corporate publicity vary considerably, ranging from purposes seemingly unconnected with security prices, such as product promotion or creating a favorable corporate "image," to seeking an "equitable evaluation" of the company's stock in the market in order to be able to obtain financing or make acquisitions more advantageously. Publicity may also be distributed for the personal gain of company officials or to the personal advantage of public relations men who acquire securities of their clients either as part of their fee or otherwise. The Special Study found instances of persons in these categories selling substantial amounts of stock shortly after the public announcement of favorable corporate developments.

The effectiveness of planned publicity—and, in the worst forms, its insidiousness—lies in its snowballing potential. The well-planned story gains momentum and scope as it travels from management to publicist to analyst to financial writer (or sometimes writer to analyst)

to adviser to salesman to investor. The techniques of the publicist are often designed to produce exactly this result; they include the placement of articles favorable to the client in the columns of the financial press, the use of "contacts" and personal influence with persons with brokerage firms and investment advisory services, and the entertainment of financial writers and security analysts. The financial press too often permits propaganda to pass as news. Financial analysts too often depend upon public relations material rather than official disclosures or independent research as the basis for the investment advice which they give the public. Not only may these practices and others described in this report seriously mislead stockholders and potential investors; they also tend to corrupt the media of communication upon which the investing public must rely for its information.

The publicity material reviewed by the Special Study had a broad range of accuracy—from straightforward reporting to material that appeared to be deliberately misleading. Most of the inaccurate publicity, however, appeared to have some basis in fact but erred in being overoptimistic. One issuer, over a period of several months, repeatedly announced plans to expand its business—plans which never came to fruition, if indeed they were ever seriously contemplated. Other companies announced earnings projections which were without basis and were not fulfilled, descriptions of new products which were still in the experimental stage, and announcements of mergers or acquisitions which were only vague possibilities. Related to the premature disclosure of corporate "news" were the problems of withholding information that should have been published and the generation or encouragement of optimistic rumors, thus giving "insiders" an unfair advantage over members of the public.

Controls over corporate publicity are relatively limited. Publicity distributed in connection with a registered offering of securities is subject to the restrictions on offers and sales of the Securities Act. Material disseminated in proxy contests is controlled by regulations under the Exchange Act. In other situations than these, the only Federal restraints on corporate publicity are the antifraud and antimanipulative provisions of the securities laws. These provisions—particularly rule 10b–5 under the Exchange Act—have proved to be of some value against the dissemination of false and misleading publicity. The policy of the exchanges and the NASD in favor of prompt disclosure by issuers of corporate news that may affect security prices is a strong weapon against fraud, but these self-regulatory bodies have thus far done little to improve the accuracy of corporate publicity or to control unethical practices in this field.

Undoubtedly, the most effective restraint on irresponsible publicity is the regular reporting and wide dissemination of reliable data—see part B of this chapter—but the worst abuses would still call for more direct measures. To some extent, the abuses can be corrected or controlled by direct prohibitions and penalties.[2] Just as the Exchange Act now provides both civil liability (sec. 18(a)) as well as criminal sanctions (sec. 32(a)) in respect of falsity of officially filed informa-

[2] The English Prevention of Fraud (Investments) Act, 1958, attempts just such a solution. Sec. 13 imposes a penalty for faudulently inducing persons to invest money, in terms broad enough to reach the fraudulent or irresponsible conduct of issuers and their publicity agents, of the type herein discussed.

tion, a statute designed to prevent misuse of channels of publicity should provide for both civil and criminal sanctions. Such a statute would eliminate the uncertainties and problems surrounding the existing antifraud and antimanipulative provisions of the securities acts and the rules thereunder, and its provisions relating to civil liability could simplify problems of proof under the existing law.

Moreover, payment of publicists in clients' securities (including options) would seem to be an appropriate and important area for disclosure on a regulated basis. The Commission's forms and regulations for annual and current reports, or for proxy statements, should require such disclosure.

Nevertheless, there are limits to what can and should be accomplished by direct regulation in this area. The volume of corporate publicity, the paramount aim of full and prompt disclosure, the difficulty of making judgments concerning specific items of publicity, and the proximity of this field to the constitutionally protected right of freedom of expression—all combine to make legal control a relatively clumsy instrument. It remains for the self-regulatory groups, official and unofficial, the business and financial communities, and the press itself to exercise their powers and responsibilities. The privilege of having securities listed on an exchange or publicly quoted under NASD sponsorship should carry corresponding responsibilities, and the exchanges and even the NASD are in a position to impose needed restraints on issuers as well as their own members. An organization such as the Public Relations Society of America can be of value not only in regulating its members but also by raising professional standards through educational and informational activities. Not least, the news media and press and public relations associations could be far more effective than they have been in imposing standards designed to separate corporate propaganda from news, and to control conflicts of interest on the part of writers of financial news.

The Special Study concludes and recommends:

1. The stock exchanges in respect of listed securities and the NASD in respect of securities enjoying the privilege of NASD-sponsored newspaper quotations should establish high standards for the dissemination of corporate publicity to which the respective issuers would be expected to conform. These might appropriately take the form of statements of policy and should cover both positive and negative aspects; i.e., types of disclosure and publicity that are required or expected and types that are discouraged or excluded in specified circumstances.

2. Consideration should be given to the enactment of a statute providing criminal sanctions and civil liability for intentional or reckless dissemination by issuers or their agents, of false and misleading statements, including forecasts unwarranted by existing circumstances, which may reasonably be expected to affect investment decisions, loans, or other transactions involving the issuer's securities.

3. The Commission's rules with respect to registration statements, offering circulars, proxy statements, and reports should be revised to require disclosure of material facts concerning compensation paid or payable to any public relations counselor or firm in the form of any equity security of the issuer, including options, warrants, or rights to subscribe to any such security.

CHAPTER X

SECURITY CREDIT

The area of security credit is unique among the subjects discussed in this report in that, although the governing provisions of law are contained in the Exchange Act, administrative jurisdiction to implement these provisions is divided between the Board of Governors of the Federal Reserve System and the Commission, with substantive matters largely in the jurisdiction of the former and responsibility for enforcement in the latter. Traditionally, the Board of Governors' concern with security credit has been related to monetary control and the total economy, whereas the Commission's concern is with security credit and its regulation as factors in the securities markets themselves. Because of the latter special concern and because the study has revealed several substantial security credit problems, it is believed appropriate to state conclusions and recommendations, notwithstanding that the recommendations relate essentially to matters in the jurisdiction of the Board of Governors. The recommendations set forth below are expressed with full regard for, and without intending to impinge in any way upon, the Board of Governors' authority to regulate security credit in relation to monetary control and the total economy, including raising and lowering margin requirements and classifying securities and loans for that purpose.

Security credit controls have been described by the Chairman of the Federal Reserve Board as one of the instruments for effectuating the credit and monetary policies of the Board. The Federal Reserve Board has exercised its broad authority by promulgation of Regulations T and U governing, respectively, broker-dealers and domestic banks. Other types of lenders are not directly covered by the regulations. Credit controls on broker-dealers limit the amount which may be lent on listed securities, and the Securities Exchange Act prohibits them altogether from lending on unlisted securities, where the purpose is to purchase or carry securities. Controls on banks limit them in the amount that may be lent on stocks to purchase or carry listed stocks, but otherwise do not limit them in lending for the purpose of purchasing or carrying other listed securities or unlisted securities. Both domestic banks and brokers are permitted to make loans secured by unlisted securities or by no collateral at all so long as the borrower's purpose is other than purchasing or carrying securities. Lenders other than domestic banks and brokers are generally free of security credit controls except in relation to borrowing from domestic banks.

The unique nature of readily marketable, publicly traded securities and the extraordinary facility of the market mechanisms that have been developed to trade them, which together make possible rapid and wide price fluctuation, cause both an initial margin and a margin

maintenance requirement to be an inherent feature of almost all security credit transactions. Public initial margin controls are considered useful in the governmental effort to regulate national credit and monetary conditions, and from the more restricted point of view of securities regulation they are indispensible in guarding against uncontrolled price declines that can result when the initial requirement is so low in relation to the maintenance requirement as to cause numerous margin calls in the event of any significant price decline. The evidence provided by the sharp market break in the spring of 1962 tends to demonstrate that, by reason of the preceding relatively high initial requirements, those loans that were regulated withstood the break well and those free of controls were much more vulnerable. As a general principle, therefore, the power should exist to extend initial margin controls to all security credit transactions to which their extension is feasible and not precluded by countervailing considerations.

The purpose for which security credit is extended may be particularly significant to the broad effort to regulate general credit and monetary conditions, but inadequately margined nonpurpose loans may be as vulnerable to margin calls as purpose loans and the disruptive effect of such calls is as undesirable in the one case as the other. Evidence now available, moreover, indicates that the aggregate amount of stock-collateralized, nonpurpose credit extended by banks, the principal source of such credit, is relatively and absolutely very great, and unless adequately margined presents a threat to market stability. Without prejudice to the retention of separate or additional margin requirements for purpose loans, it appears to the Special Study that authority should exist and consideration should be given to extending some type of initial margin requirement to all or some categories of nonpurpose loans collateralized by actively traded stocks, as the Federal Reserve Board may find appropriate.

Again with particular reference to the securities markets, the present pattern of credit regulation is marked by other disparities that may be explained historically but do not appear to be justifiable at present. These arise principally in the distinctions drawn between exchange-listed and over-the-counter securities and in the further distinctions drawn between lending by broker-dealers and lending by banks. Since over-the-counter securities and their markets are far more heterogeneous than listed securities and their markets, it would not be appropriate to equate all of the former to all of the latter, but for that segment of over-the-counter securities reasonably resembling listed securities in pertinent respects it would appear appropriate and equitable to remove or at least minimize some of the present distinctions. The most pertinent considerations in defining that segment are the availability of reliable information so that risks may be appraised, the availability of reliable quotations so that values may be assigned to pledged securities, and the availability of market depth so that collateral will not be unduly frozen in the hands of lenders.

Implementation of recommendations in chapters VII and IX would have the result of assuring a fund of reliable information for "OTC-listed" securities through required disclosures by issuers; establishing more dependable and informative interdealer and publicly disseminated quotations; identifying primary market makers of each over-the-counter security as a measure of depth of dealer interest; and

presumably (through selection of securities to be included in newspaper and other publicly disseminated quotations) singling out those securities having widest public interest and activity. It would therefore also be appropriate to permit broker-dealers to extend credit on some over-the-counter securities to purchase or carry listed or unlisted securities as and to the extent provided by regulations of the Board of Governors. Assuming implementation of the above recommendations, extension of credit by broker-dealers might be permitted on "OTC-listed" stocks and convertible bonds included in any officially recognized public quotation system, subject to such exclusions or limitations as the Board of Governors may provide as to particular categories of such securities. The margin limit for such securities or particular categories of them might be fixed in relation to, but need not necessarily be the same as, the limit prevailing at any time for listed securities.

Stocks that are actively traded in over-the-counter markets as well as some convertible bonds that are actively traded in such markets or listed on an exchange may be subject to price fluctuations to as great a degree as are listed stocks. The categories of securities referred to in the preceding sentence probably coincide generally, but not necessarily exactly, with the categories referred to in the preceding paragraph as eligible for extension of credit by broker-dealers. Minimum initial margins should be required on these securities (as they may be more precisely defined in the regulation) when used as collateral for bank loans. It is not contemplated that such a requirement would restrict banks from lending at their discretion on inactively traded over-the-counter stocks, convertible bonds or nonequity securities.

The absence of any controls on lenders other than broker-dealers and domestic banks "unregulated lenders") affords a significant loophole in the regulatory scheme and may have had the effect of reducing the effectiveness of credit regulations in those areas in which they have been imposed and also facilitating the activities of persons bent on securities law violations. Controls should be extended, to the extent feasible, to all persons regularly engaged in the business of lending on securities and adequate information-gathering about their activities should be instituted.

The Special Study concludes and recommends:

The Board of Governors of the Federal Reserve System has primary responsibility for the regulation of security credit in relation to monetary control and the entire economy. The Commission's concern, more limited in nature, is with security credit and its regulation as factors in the securities markets themselves. While recognizing the primary and broader responsibility and authority of the Board in this area and without intending to impinge upon that responsibility and authority in any way, the Special Study nevertheless believes it appropriate to express the following conclusions and recommendations relevant to the Commission's more limited area of concern:

1. Data assembled by the Special Study, with cooperation from the Federal Reserve System, are believed by the Special Study to confirm the general principle that the Board of Governors should have authority to extend some kind and degree of margin control on all loans collateralized by securities whose forced liquidation in a declining market would have a significant market-disruptive

potential, including some loans now classified as "nonpurpose." Unless the Board of Governors itself feels that further studies are necessary before requesting such authority, section 7 of the Exchange Act should be amended to authorize the Board of Governors to establish initial margin requirements on loans collateralized by securities, irrespective of their purpose, for banks and those lenders encompassed in paragraph 5 as well as broker-dealers. The authority should be sufficiently flexible so that the Board may take into account both the general economic and credit needs of the country and the immediate needs of the securities markets, enabling it to establish separate initial margin requirements adapted to those separate purposes. Pursuant to such authority, the Board should appropriately amend Regulations T and U to encompass such specific categories of "nonpurpose" loans collateralized by securities and establish such margin levels as may seem appropriate to it.

2. Section 7 of the Exchange Act should be amended to give the Board of Governors of the Federal Reserve System authority to permit broker-dealers to extend credit on such over-the-counter securities or classes thereof as it may from time to time designate, with such advice or assistance as it may request of the Commission. The Board's authority should permit it, in establishing initial margin requirements, to differentiate between listed securities and some or all over-the-counter securities and among various classes of over-the-counter securities. Pursuant to such authority, and assuming implementation of recommendations in chapter IX.B. for extension of investor protections (financial reporting and proxy and insider-trading controls) to certain over-the-counter securities, the Board should appropriately amend Regulation T to permit broker-dealers to extend credit on specified classes of stocks and convertible bonds included within the "OTC-listed" category referred to in chapter IX.B. for which reliable, current information is available.

3. Section 7 of the Exchange Act should be amended to empower the Board of Governors of the Federal Reserve System to impose initial margin requirements on actively traded over-the-counter stocks and convertible bonds used as collateral for loans by banks. This power should extend both to loans for purchasing or carrying securities and also for other purposes. The Board's authority should permit it to designate from time to time the classes of over-the-counter stocks and convertible bonds to be deemed actively traded for this purpose, with such advice or assistance as it may request of the Commission. Pursuant to such authority, the Board should amend Regulation U to extend margin controls to bank loans on those categories of over-the-counter stocks and convertible bonds so designated, which might coincide with, or differ from, the categories designated in respect of extension of credit by broker-dealers. It is not intended that such a requirement restrict banks from lending at their discretion, as at present, on inactively traded over-the-counter stocks, convertible bonds, or nonequity securities.

4. Whether or not the other recommendations herein are adopted, Regulation U should be amended so that loans collater-

alized by, or to purchase or carry, listed convertible bonds are subject to margin requirements similar to those on loans collateralized by stock to purchase or carry listed stocks, with appropriate exceptions or differentiation for convertible bonds whose market prices do not primarily reflect the availability of the conversion privilege.

5. Under the authority now provided by section 7 of the Exchange Act, the Board of Governors should subject "all persons" who make loans to U.S. residents, on the collateral of securities traded in U.S. markets, to the same requirements as are applicable to domestic bank loans collateralized by such securities, subject to appropriate exclusions for lenders in specified categories such as those not engaged in a business of lending or those never having aggregate outstanding security loans of more than a specified amount, say, $100,000. To aid in enforcement, domestic lenders should be required to keep specified records and file periodic reports, and domestic banks should be prohibited from furnishing any form of assistance or service to any foreign lender in connection with any loan not in conformity with such requirements.

CHAPTER XI

OPEN-END INVESTMENT COMPANIES (MUTUAL FUNDS)

[Part A (Introduction) briefly describes the structure of the mutual fund industry, outlines the growth of the industry since the enactment of the Investment Company Act of 1940, and delineates the area of inquiry of the chapter.]

Part B. Selling Practices

The extraordinary growth of the mutual fund industry in the 23 years since the adoption of the Investment Company Act has raised a group of problems seemingly not contemplated by its framers. The very structure of the industry, unique as it is in the securities industry, creates special problems of concern for the adequate protection of investors. Mutual fund shares, alone among securities offered to the public, are constantly redeemable and continuously offered by their issuers. Their statutorily required redeemability has been taken by most funds and their sponsors to justify, if not require, the creation of retail sales forces to facilitate the constant offering of shares. The growth of these sales forces is further stimulated by the frequently close relationship of the principal underwriters of mutual funds to their investment advisers, whose compensation is geared to the total net asset value of the fund and is increased as sales increase the size of the funds. Since generally the entire burden of the selling cost of mutual funds is borne by the purchasers of new shares (unlike the usual corporate offering at the market in which the issuer itself absorbs the cost of offering new shares), the funds' sales organizations are not restrained in their selling operations by considerations of costs to the funds. The sales organizations are also protected by the "fair trade" aspects of the Investment Company Act, the NASD rules, and the private sales agreements of the underwriters governing the prices and spreads at which shares can be sold.

Mutual funds and contractual plans are sold to investors by securities salesmen employed by a wide variety of firms, including firms engaged in the general securities business such as stock exchange member firms. The standards of selection, training, and supervision of salesmen for such firms have been described in chapters II and III, where it is noted that in some cases the requirements for salesmen restricted to sales of mutual funds are lower than those for general securities salesmen. Sales of no-load funds are handled without the use of such sales organizations as are described below. However, a substantial proportion of all mutual fund shares and a very large proportion of contractual plans are sold by salesmen of large- or medium-sized firms specializing in the sale of mutual funds, some of the largest of which are affiliated with particular funds, their investment advisers and principal underwriters, and a few of which are not

members of the NASD or other self-regulatory organizations. The report's description in this chapter of selling organizations, selling practices, and training and supervision of salesmen applies principally, although with significant exceptions, to the sales organizations specializing in mutual fund shares.

The large- and medium-sized retail sales organizations which have grown up in the mutual fund industry are characterized by a particularly high turnover of salesmen. The heavy turnover requires them to engage in a continuous program of extensive recruiting, and recruits are overwhelmingly persons totally inexperienced in the securities business. Most sales organizations in fact prefer inexperienced recruits, though they look with favor on sales experience in other fields. The emphasis on inexperienced recruits in turn requires the sales organizations to supply them with such training as will be sufficient to enable them to pass qualifying examinations, where applicable, and to impart to them the tested techniques of mutual fund selling. Sales trainees are almost never paid during their training period, and their training is generally brief and conducted in the evenings on a part-time basis, sometimes in formal classroom-type programs but more often in informal discussions with a sales supervisor. The limited curriculum consists of two parts. The first part primarily provides such rudimentary introduction to the securities business, the Federal and State securities laws, the rules of the NASD and the Federal tax laws as will enable the trainee to pass the NASD examination (except for the large nonmember organizations) and such State examinations as may be required. The balance of training aims largely at acquainting the recruit with the product he will sell and instilling in him effective methods of prospecting, making presentations, and closing.

The mutual fund salesman, thus briefly trained, is then sent out to the public to sell mutual fund shares and contractual plans. He sells almost exclusively on straight-commission compensation arrangement, rarely with a draw against commissions, and often with the commission schedule weighted to favor sales of the shares of the fund or funds sponsored by his employer. His first sales, apart from those made to himself, are generally made to prospects from his personal circle of acquaintances. To be successful, however, the fund salesman must constantly enlarge his circle of prospects. This enlargement is accomplished through various standard prospecting techniques: Requests for referrals of names from persons to whom he has made sales, "radiation," mailings, telephone calls, and the "cold turkey" call.

In his prospecting and presentations the mutual fund salesman is generally approaching a person who has not previously evinced an interest in buying mutual funds, and he often does not reveal at the outset that he is selling them. He frequently represents himself as an expert in financial planning, but the extent of financial planning performed by most fund salesmen is largely limited to persuading a prospect to invest a portion of his assets or earnings in equity investments. In many organizations the sales presentation is expected to be highly emotional and dramatic in tone, playing on such factors as fear, pride, and patriotism. As one industry representative has said of the mutual fund salesman:

> He must do the approaching. Nor can he succeed in the effort of claiming attention with cold recitations of facts, figures, and legalistic jargon. He must be imaginative. He must color his approaches with excitement and drama.

He must reach human emotions. No laws or regulations will change human nature.

A survey of mutual fund investors prepared for the study by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania (the Mutual Fund Investor Survey) describes the "typical" mutual fund and contractual plan purchaser, while noting the variations that lie behind the overall view, as a man in his middle-to-late forties, married, with three dependents, a high school education, a job paying an annual income of $5,000 to $10,000, and life insurance of $10,000 to $15,000. However, the survey also notes a general tendency of the proportion of contractual plan buyers to rise as levels of education, income, and occupational skills decline. Among contractual plan purchasers in the lower income brackets, the survey notes that a high proportion are heads of families in low-paying jobs, with a high ratio of their contractual plan commitment to their annual income. It reports, too, that among contractual planholders redeeming their accounts, there is a substantial proportion of planholders in low-income brackets. There is clear evidence of the use of many contractual planholders of their plans as a source of "rainy day" savings and of the purchase of plans by persons with few or no other financial reserves. While emphasizing the lack of comparable data for other types of investors, the survey notes the low level of knowledge of mutual fund investors regarding their funds. The survey comments on the important influence of salesmen in the investment decisions of purchasers, particularly among contractual planholders in the lowest income group.

In relation to the sales presentations made by salesmen, the survey states that in a majority of cases sales representatives were reported to have made no inquiries about the income, financial assets, and financial obligations of the purchaser, that 20 percent of regular account purchasers and 10 percent of contractual plan purchasers said they had received no prospectuses, and that many purchasers reported being told that shares were like savings accounts and that fund management and investment policies were supervised or controlled by the Federal Government. While most purchasers reported that sales charges had been explained to them, relatively few could make a reasonable estimate of what they were. Although the first-year sales charges on contractual plans are widely sold as an advantageous penalty which will stimulate saving, only about 40 percent of plan purchasers could reasonably estimate this charge, and a quarter of those redeeming plans who were aware of the impact of the front-end load said that they had not anticipated the impact when they made their purchase. As to future expectations conveyed by salesmen, the survey reports that a majority of fund salesmen exercised restraint in their discussion of prospective changes in fund share market values, but a significant number emphasized a strong chance or near certainty of price increases. In the light of a number of indications of lack of sophistication on the part of mutual fund investors, the survey suggests the need for additional safeguards for their protection.

The principal sales abuse with respect to which investors need protection is high-pressure selling, which may involve salesmen making misleading representations to customers and may lead to the sale of shares or plans to persons for whom their purchase is unsuitable or to

switching shareholders from one fund to another for the sake of commissions. To some extent the industry is reluctant to concede that questions of suitability can ever arise in the sale of funds or plans, but both the Mutual Fund Investor Survey and the study's own evidence concerning contractual plan redemptions and lapses leave no doubt that a substantial number of plans are sold to persons for whom, because they have insufficient income or inadequate other financial resources, they are likely to be unsuitable investments. The industry itself recognizes the importance of one's having life insurance and adequate financial reserves for emergencies before making equity investments.

Since mutual fund salesmen generally sell away from their own offices and in the offices and homes of their customers, and since they are generally selling to new customers rather than engaging in continuing transactions for an existing clientele, their supervision presents problems sharply different from the problems of supervising general securities salesmen. The selling activities of most mutual fund salesmen appear to be largely unsupervised. The selling organizations do have hierarchies of supervisory personnel, but the primary activity of the supervisors is selling, stimulating sales, and recruiting, and the control which they exercise over the sales tactics of their salesmen is limited. Home office administrative controls, exercised through a review of sales applications at a distance from the point of sale without substantial information concerning the customer's financial status, can at best apply only to the most obvious types of abuse. Only a few companies have established staffs of roving field investigators to check on salesmen, and these staffs are small in size. For a number of dealers who are members of the Association of Mutual Fund Plan Sponsors, Inc., an industry trade organization, it is evident that in the sale of contractual plans they view the principal control over sales abuses to be the 30-day refund privilege for new purchasers which members of that association offer. However, the number of persons to whom the offer is made who nevertheless pay no installments after their initial payment and who redeem their plans or lapse in payments in the plans' early stages suggests that the 30-day option may be only moderately effective.

Federal controls over mutual fund sales practices include the general antifraud provisions of the securities laws, the disclosure requirements of the securities laws, and the Commission's Statement of Policy covering mutual fund sales literature. While its powers are sufficient to require appropriate sales restraint in the use of the written word, the Commission is presented with difficult enforcement problems in the characteristic home selling of mutual funds through oral presentations. In addition, the Commission's regular inspection programs are difficult to gear to detection of the type of abuse which may most characteristically occur in the sale of mutual funds.

The NASD is the only industry self-regulatory body which significantly controls the mutual fund retail sales organizations, although a few of the largest of those organizations which are wholly integrated are not members of that association. The Commission looks largely to the NASD for enforcement of the Statement of Policy, and the NASD has brought a number of disciplinary actions relating to its violation, as well as for charges of switching funds and "selling dividends." For the NASD too, however, the home sale of funds makes detection of high-pressure sales a difficult problem.

The sale of contractual plans poses a special problem. These plans are basically long-range programs for investing in the shares of a particular mutual fund on an installment basis but with the unique feature that the purchaser is required to pay a substantial portion of the total sales charge in advance (the "front-end load"). As a consequence of this front-end load a purchaser in essence commits himself to purchase shares of a particular mutual fund over a period of time—typically 10 years—on the basis of information concerning the fund supplied to him at the time he makes his first purchase. If adverse personal circumstances render the purchaser financially unable to continue his purchases, if his investment objective changes, if the fund no longer enjoys his confidence, or if for any other reason he no longer wishes to invest in the fund, he discontinues his purchases only at the cost of a penalty. In this respect contractual plans, which contemplate a commitment to purchase securities far in the future on the basis of information received in the present, are an exception to and appear somewhat inconsistent with the underlying philosophy of the securities laws that an investor shall have current information available to him at the time of purchasing securities on which to base his investment decision.

The security which the contractual plan purchaser acquires is much more complex than that acquired by the direct purchase of mutual fund shares. The prospectus which describes what the contractual plan purchased has bought (and what it cost him) is typically longer and more difficult to understand than the prospectus which is delivered to the direct purchaser of mutual fund shares. Paradoxically, a substantial number of these complex securities are sold to the least sophisticated portion of the investing public. A high proportion of contractual plan purchasers are making their first purchase of equity securities. Many of them are persons in low-income brackets with heavy family responsibilities and no financial resources apart from their wages or salaries. A large proportion of these persons do not understand the amount or the impact of the front-end load. They are, for the most part, unaware that mutual fund shares may be acquired in a less expensive way through a voluntary or level-load plan or through no-load plans.

The sale of complex securities to unsophisticated investors in a way which permits the investor fully to understand and evaluate the intricate merchandise he is acquiring is at best a difficult task. High-pressure selling, inadequate training of and lack of adequate supervision and control over salesmen, all of which appear to be present to a high degree in the sale of contractual plans, make its accomplishment most unlikely. The front-end load structure encourages high-pressure selling. The substantial commission which a salesman receives from the initial 13 payments, particularly when the purchaser prepays a number of them as he is usually urged to do, gives the salesman a strong incentive to sell these plans regardless of the circumstances of the purchaser in order to realize commissions on at least the front-end portion of the load.

The Special Study statistics on persons purchasing plans in February 1959 demonstrate the heavy cost which many contractual plan purchasers have paid in order to invest in equity securities. After 3½ years, one-sixth of all contractual plan purchasers, by virtue of redemptions and lapses in payment, had paid an effective sales load of

50 percent of the amount paid in (or 100 percent of the amount invested for them in fund shares). An additional one-sixth of these purchasers had redeemed or lapsed, having paid an effective sales load in excess of 18 percent. Thus, about one-third of all such purchasers had paid an effective sales load of from two to five times the 9-percent maximum overall charge for completed contractual plans permitted under the Investment Company Act.

The contractual plan industry justifies this front-end load on three principal grounds: few people lose money while in the long run most people make money; the "penalty" of the front-end load is necessary to stimulate most people to regular savings habits; and the advance payment is necessary to adequately compensate salesmen for bringing the benefits of equity investments to persons of modest means. None of these justifications is persuasive.

In recent years roughly 15 percent of contractual plan purchasers have redeemed with losses within 5 years of purchase of their plans. This is a substantial number, particularly in light of the recent history of generally rising markets. Further, as indicated above, an even more substantial number of purchasers have paid an extremely high sales cost for their investments. Even in the absence of these points, the industry's first argument is not persuasive because it ignores the fundamental question of the relationship of sales charges to the amounts invested, and instead—unique in the securities industry—attempts to justify a sales charge on the basis of the ultimate success of investors taken in the aggregate.

The extent to which the penalty feature of the front-end load actually serves to encourage regular investing habits is also open to question. The Special Study figures on February 1959 plan purchasers also show that 3½ years later, more than one-third had not persisted as regular savers, while the balance included a number who might be called occasional investors. Even for the regular investors it should be noted that stimulants other than the front-end load penalty, such as mailed reminders and the concomitant purchase of completion insurance—both available in some voluntary plans as well as in contractual plans—have played their part in developing savings habits. The front-end load itself provides no inducement for salesmen to encourage savings habits, except during the first year when high commissions are deducted from plan payments. Thereafter, the load will be less than that of a voluntary plan, and it would seem to follow that the salesmen's inducement to encourage savings over the life of the plan would be less than in a voluntary plan. Furthermore the inducement which salesmen have in the first year to encourage customers' saving is subverted by the practice of obtaining prepaid installments subject to the front-end load.

In the sale of contractual plans the actual investment performances of contractual plan purchasers are generally ignored or occasionally misstated. In the past they have not been required to be disclosed in the prospectus, and salesmen have been free to point to tables showing the past growth of an investment in the plan they are selling, based on the ideal assumption of a perfect investment record, without noting that a substantial majority of plan purchasers come nowhere near achieving such a record of payments. Salesmen of many funds are encouraged to tell purchasers that 9 out of 10 contractual planholders

complete their plans, with the implication that they complete them according to schedule. The actual rates of redemption and lapse in payment by planholders are not disclosed.

The argument that the front-end load is necessary to finance the sale of mutual fund shares to the public is overstated. Clearly, mutual funds can be, and are, sold without a front-end load. Indeed, California, the State which in 1962 led all others in mutual fund sales, prohibits the sale of contractual plans.

A byproduct, of questionable value, of the front-end load is that the newcomers who are attracted into contractual plan selling generally make their initial, and often sole, sales to their relatives and intimate friends. Clearly the soundness of such sales may often be questioned.

The study's analysis of the problems related to the sale of contractual plans should not be misconstrued as criticism of the value of the underlying securities, as to which the study takes no position. Nor should the study's analysis be taken by any planholder as a reason for redeeming any plan certificates. Early redemptions of plans, as has been noted, almost inevitably result in losses to the planholders, and the questions raised by the study, being unrelated to the merits of the investments themselves, should not result in investors' incurring losses on investments already made. They are addressed, on the contrary, to the issue of whether (or the conditions under which) contractual plans should be permitted to be sold in the future.

In view of the Commission's continuing comprehensive program of study of fundamental structural problems of the investment company industry, it would be premature for the Special Study to promulgate definitive recommendations on the isolated segment of the contractual plans. It is not inappropriate to note, however, the conclusion of the Special Study that the combined factors of the incentive to high-pressure selling which the front-end load provides to salesmen, the essentially unsupervised nature of home-selling of plans, the complexity of the security sold and the lack of financial sophistication of so many of the purchasers of plans create a problem of a fundamental nature which cannot be solved through the mere application of the doctrines of disclosure.

It is the front-end load structure itself and the economic incentives which it gives to salesmen which are responsible for the failure of the disclosure concept adequately to protect the public from untoward selling pressures in contractual plan sales. Under these circumstances only compelling reasons can justify the continued existence of the front-end load. The study has concluded that the justifications advanced by the industry are hardly persuasive and certainly not compelling. Therefore serious consideration should be given to the elimination of future front-end load plans.

Should it be concluded in connection with the pending broad study of investment company structural problems that prohibition of future front-end loads is not called for, at a minimum their permissible limits should be fundamentally altered. The maximum amount deductible for sales charges from early installments should be lowered, the installments from which they are deducted should be spread out, and the deduction of sales charges from prepayments should be prohibited in an amount in excess of the deductions from the later installments under the plan.

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The principal industry justification for the existence of a front-end load is that some persons need the stimulus to savings which prepaid sales charges provide. If persons wishing to subject themselves to a penalty provision for the discipline which they believe it will give them are to be permitted to do so, they should do so consciously and voluntarily, with an awareness of the alternative forms of mutual fund investment. At present, a high percentage of investors in contractual plans are unaware of the existence of accumulation plans which do not involve a front-end load, some of them with completion insurance and some with low initial and continuing payments. They should not subject themselves to the front-end load unwittingly or for lack of a clear alternative. If the front-end load is not to be prohibited, any fundamental alteration of its structure should be combined with a requirement that any mutual fund sales organization offering a front-end load contractual plan to any person simultaneously, offer such person the opportunity to purchase shares of the same underlying fund under a level-load voluntary plan, but otherwise on substantially the same terms. Such a provision would not, of course, compel any contractual plan sponsor to offer voluntary plans on an uneconomic basis. It would, however, preclude the offering of contractual plans except on a basis reasonably calculated to insure that the purchaser of a contractual plan had made a conscious election to impose a penalty upon himself in the event of his failure to make the required payments.

The Special Study concludes and recommends:

1. The study was not concerned with and has not attempted to evaluate the merits of mutual fund shares as an investment medium, and nothing contained in this report should be construed as an endorsement of criticism of investment company shares generally, or of those of any particular company, or as a basis for purchasing or redeeming any such shares. However, certain factors peculiar to the mutual fund industry create pressures toward undesirable selling practices. Evidence suggests the existence of such practices to an unfortunate degree. Industry representatives and the NASD, in consultation with the Commission, should jointly undertake a program designed to eliminate such tactics and devices through the adoption of interpretations of the Rules of Fair Practice. The further development of secondary supervisory controls by industry members is desirable, and the NASD should increase its activities in the surveillance of selling practices outside of the area of advertising and sales literature. As recommended in chapter II, membership in the NASD or another registered securities association should be required of all mutual fund selling organizations, and any such association should be required to maintain standards equivalent to those adopted by the NASD in accordance with this recommendation. Reference is also made to the recommendations in chapter II concerning the qualification and registration of salesmen.

2. Prospectus requirements should be further refined to assure that basic information is brought clearly and conspicuously to the attention of the prospective investor. The Commission should require a summary on the cover, or as prominently as possible at the beginning of each prospectus, of the sales charges, expense

ratios, advisory fees, performance objectives, and other basic information, and should require disclosure of any special or extra compensation arrangements for the sale of particular funds by mutual fund salesmen or of the fact that the salesman can only offer a particular fund or funds. It should amend the Statement of Policy to require that tables which are used to reflect results of plan completions also indicate performance records of plan investors. It should also consider an exercise of its rulemaking power to define deceptive practices in connection with recommendations of switches from one mutual fund to another.

3. In conjunction with its comprehensive program of study of the investment company industry, the Commission should recommend to the Congress legislation amending the present provisions of the Investment Company Act of 1940 which relate to contractual plans. Consideration should be given to the abolition of any future front-end load. If it should be concluded that such abolition is not called for, such legislation should both substantially limit the amount and method of application of any such load and prohibit the offering of front-end-load contractual plans by any mutual fund sales organization without the simultaneous offering of a level-load voluntary plan for shares of the same fund and (except for prepayment of selling charges) on substantially the same basis.

PART C. RECIPROCAL BUSINESS—THE PROBLEMS OF ALLOCATING MUTUAL FUND PORTFOLIO BROKERAGE

Reciprocity, or "doing business with people who do business with you," is an accepted custom of the business world in general and the securities industry is no exception. In the mutual fund industry, however, it takes on a unique characteristic. While it is the mutual funds themselves whose portfolio transactions provide the brokerage which constitutes the currency of reciprocity, its principal beneficiaries are not the funds but their investment advisers and principal underwriters.

The unusual structure of reciprocal business practices in the mutual fund industry traces principally to the minimum commission rate schedule of the New York Stock Exchange and its antirebate rule. The large volume of transactions executed by mutual funds in the exchange market are sufficiently profitable to the member firms which handle them that these firms are willing to do so for 40 percent of the amount to which the commission rate entitles them. Since the balance of 60 percent cannot be returned to the funds themselves without violating exchange rules, the executing broker-dealers pay give-ups, as instructed by the funds or their investment advisers, to other member firms. The firms to which the give-ups are paid are those which have rendered services in some way related to the fund, their advisers or underwriters. The principal service so rewarded is the sale of fund shares; others include such things as rendering statistical or research services or providing wire facilities. The funds do not profit from the sale of their shares and they pay an advisory fee—geared to their size—for the investment advice they receive from their advisers. The rewards of reciprocity thus flow to the broker-dealers who have pri-

marily benefited the advisers and their frequently related principal underwriters rather than to the funds.

While the rules of the New York Stock Exchange have created the particular character of reciprocal business in the mutual fund industry, the problems are not confined to the community of NYSE firms. Nonmember firms are as eager for additional compensation for their sales of fund shares as are member firms. As a result there have developed intricate patterns which permit them to share the large amounts of brokerage generated by the funds. Firms which are members of regional exchanges are enabled to participate through transactions on those exchanges in dually traded securities executed by firms with dual memberships. For firms which are members of no exchange the problem is more difficult. Sometimes they are rewarded by participating in a selling group in a primary or secondary offering of a security to be purchased or sold by the rewarding fund. More often they are required to take their compensation in kind rather than cash through a service give-up from a NYSE member firm of sales promotional or training materials. On occasion they may receive over-the-counter give-ups, directly or through a device known as interpositioning. Such over-the-counter give-ups, including interpositioning, raise serious questions of conflicts of interest, however, since in the over-the-counter markets where no minimum commission structure exists there is no reason why fund shareholders rather than secondary broker-dealers should not be entitled to the benefits of quantity discounts.

The existence of substantial sums of fund portfolio brokerage available as extra compensation for the sale of fund shares can lead to undesirable sales pressures by fund retailers. Competitive demands or a desire to increase investment advisory fees can lead to portfolio churning by investment advisers. Both possibilities have concerned industry representatives in recent years.

Ultimately the solution of the problems lies at their source: the NYSE minimum commission rate schedule. So long as the funds cannot themselves benefit from the economies created by their mass purchasing power, the complexities and potential problems of the third party beneficiary system will continue. Various problems in connection with the Exchange's rate structure are discussed in chapter VI, but it is appropriate to observe in connection with this review of reciprocal patterns of mutual fund brokerage allocations that in the consideration of any revision of the rate structure the question of introducing some form of volume discount should be high on the agenda.

Granting that the existing commission framework may explain many of the existing patterns of reciprocity, there are some which it cannot justify. There is no reason for funds or the regulatory agencies to countenance give-ups in the over-the-counter market. The NASD should outlaw participation in them by its members and discipline such violators as come to its attention. The prohibition should cover over-the-counter transactions in listed securities as well as unlisted ones, and should be designed to prohibit its evasion by deliberate resort to a market for the purpose of taking advantage of a minimum commission rate structure.

The Special Study concludes and recommends:

1. The pattern of reciprocal business in the mutual fund industry is unique. The economies of the volume of securities transactions generated by the mass purchasing power of the funds for the most part are of minor benefit to the funds themselves. The primary beneficiaries are their investment advisers and their frequently related principal underwriters, who to a large extent use reciprocity to reward the sales efforts of fund retailers, thereby increasing their own rewards. The use by fund advisers of investment advice and research provided by brokerage firms in return for fund brokerage, without diminution of their investment advisory fees, is another indication of the manner in which they are the primary beneficiaries of reciprocal business. This unbalanced reciprocal structure is a direct outgrowth of a minimum commission rate structure which prohibts volume discounts and rebates. In the broad study of the commission rate structure recommended to the Commission in chapter VI–I, appropriate consideration should be given to the desirability and appropriate form of a volume discount from the viewpoint of mutual funds.

2. While some reciprocal practices in the mutual fund industry are justifiable under the existing commission structure, the over-the-counter give-up in its various forms, including interpositioning, is in flagrant conflict with the duty of a fund and its adviser to obtain best terms in its securities transactions unless the advantages of any such give-up can be clearly demonstrated. The NASD should amend its Rules of Fair Practice to prohibit the practice among its members in over-the-counter transactions in any security. The Commission should consider the issuance of a Statement of Policy on the subject.

3. Mutual fund directors and those who transact portfolio business for them are primarily obligated to obtain the best available terms in such transactions for the benefit of fund shareholders without regard to the reciprocal business aspects of the transaction, and to see that the funds themselves receive the maximum benefits available from any such reciprocal business. The choice of market for portfolio transactions should be made exclusively from the point of view of these obligations, and not on the basis of rewarding broker-dealers for their sales of fund shares or for other services. The NASD and the Investment Company Institute should promulgate rules and standards of conduct designed to assure that the primary obligations to fund shareholders in the handling of fund portfolio transactions are recognized and enforced.

PART D. INSIDER TRANSACTIONS IN PORTFOLIO SECURITIES

The nature and extent of trading by those having access to inside information on mutual fund portfolio transactions, the policies of the investment company complexes concerning such trading, and the implementation of such policies were examined by the Special Study in relation to the portfolio transactions of 28 representative mutual funds whose assets at December 31, 1961, aggregated $5.2 billion. In its survey of insider trading the study attempted to determine the extent

to which situations of potential conflict exist in the industry, without for the most part characterizing the manner in which they have been resolved. In the light of the high position of trust of the persons and companies covered by the survey, however, the overall industry figures on industry insider trading are significant. As many as 14.4 percent of all persons and companies included in the survey had traded in securities during the same period as the fund, and 8.0 percent traded within 15 days prior to the fund. Over a brief 7-month period, at least 30 percent of the access persons and companies traded in fund portfolio securities.

From a more detailed discussion of the transactions relating to five out of eight funds selected for more intensive study, it also becomes clear that fairly extensive trading in mutual fund portfolio securities by insiders takes place. The specific situations described vary considerably in quantities and relative prices, degree of relationship between fund transactions and individual transactions, and possible motivations or explanations. There are, however, several instances where insiders' transactions seem to have been clearly designed to benefit from related fund transactions.

The survey demonstrates broad industry awareness of the problems raised by the conflict of interest which may exist when an individual or entity privy to the mutual fund's investment recommendations and decisions engages in trading for his or its own account in securities purchased or sold by the fund. Taking advantage of inside information in advance of fund transactions for personal gain is widely regarded in the industry as unethical. Overwhelmingly, the funds and their investment advisers reported the existence of policies which reflected in one way or another their awareness of the ethical problems involved.

However, despite widespread existence and application of policies, there are substantial variations in the policies themselves and the manner in which they are enforced. Some of those examined were vague, broad, and equivocal, while others were firm and clear. It was somewhat surprising, in view of the extent of trading by insiders reported to the study, that only one fund indicated knowledge of any violation of its policies, and that was said to be inadvertent. The vagueness of some policies and the variety of others suggest considerable disagreement in the industry as to the nature and extent of obligations in this area.

The results of the survey indicate that considerably more attention to the subject of insider trading is called for on the part of the mutual fund industry and the Commission. The situation calls both for clarification and implementation of higher standards for the industry.

The Special Study concludes and recommends:

1. Each registered investment company should be required to adopt a written policy covering insider trading, and provisions for its implementation, which are satisfactory to the Commission, and should be required to report any violations of policy to the Commission. The minimum standards for such a policy which would be acceptable to the Commission should include: (a) Coverage of all officers, directors, substantial stockholders, and advisory employees of the investment company, its investment adviser, and principal underwriter, but with appropriate recogni-

tion of problems of independent, unaffiliated directors; (b) prohibition of purchases or sales of securities, directly or indirectly by any person covered by the policy, within 30 days prior to or following the date of a portfolio transaction in the same security issue, subject to reasonable exceptions, as in the case of hardship or with respect to such types of securities as the Commission might exempt from application of such policy; (c) a requirement that persons covered by the policy report to the investment company on transactions in issues in its portfolio, such reports not to be made public but to be available for Commission inspection, and (d) appropriate provision for sanctions in the event of violations of the policy.

CHAPTER XII

THE REGULATORY PATTERN

[Part A (Introduction—Self-Regulation in the Securities Business) discusses generally the concept of self-regulation in the securities industry and the need for public supervision of self-regulation.]

PART B. THE NEW YORK STOCK EXCHANGE AS A SELF-REGULATORY INSTITUTION

The influence and prestige of the New York Stock Exchange among the self-regulatory institutions are unrivaled. It occupied a singular position in the securities industry when the Securities Exchange Act of 1934 was adopted, and this is at least equally true today. The Exchange is uniquely important as an agency of self-regulation not only because of its outstanding importance as a securities market but also because of the dominant position of its membership in the entire securities business. Thus, the quantity and quality of its self-regulatory activities are of special significance: Considered by themselves and in comparison with other self-regulatory agencies, they are the most important single measure of the strengths and weaknesses, the accomplishments and limitations, of the self-regulatory concept.

It is appropriate to repeat here as to the NYSE's self-regulatory activities what has already been said in part A on self-regulation generally—that it has basically proved itself in practice despite the shortcomings pointed out below. The study's discussion of the latter is not intended to overshadow or disparage the record of accomplishment but to point toward an even stronger future role. That some of the problems of self-regulation have their counterparts in the Commission's performance of its total role may be seen at various places in the Report and particularly part I of this chapter.

The Exchange has conceived of its regulatory role very broadly; it has regarded very few, if any, aspects of its member's business—and therefore of the entire securities business—as being outside the sphere of its concern, and to one degree or another it has addressed itself to the most important of them.

The Exchange has provided constructive leadership and excellent results in many important areas. Its regulatory performance must be rated unsatisfactory in others, however, sometimes seriously so. The Exchange's accomplishments impressively illustrate its ability and potential to raise industry and corporate standards. This and other chapters of the report, however, also reflect areas where the Exchange has been willing to accept the status quo uncritically, where it has failed to perceive new needs for self-regulatory intervention, or where its intervention has been halfhearted or its methods have become outmoded. It has sometimes seemed to be excessively concerned

with defending its members from public criticism and insufficiently concerned with governing their conduct in a public market as the Exchange Act requires it to do. That the Exchange has failed to bring its accomplishments in all areas to the level of quality achieved in some is the more regrettable in view of the opportunity afforded by its dominant position and influence.

The unsatisfactory performance in some spheres of self-regulation undoubtedly has many explanations. Among them, there appears still to be a disproportionate influence of floor professionals in the government of the Exchange, stemming ultimately from the allocation of voting power in the Exchange constitution. Only regular members, i.e., holders of "seats," are entitled to vote at Exchange elections and on matters requiring approval by a vote of the membership. Only 97 seats, or 7 percent, are held by those firms providing 50 percent of public commission business, 48 percent of the registered representatives, and 42 percent of branch offices, whereas at the other end of the scale, over 800 seats, or 60 percent, are held by members whose firms do 10 percent of public commission business, have 10 percent of the total registered representatives and 13 percent of the total branch offices. Of 29 elected governors, 17 are required to be regular members, and 14 of them, including the chairman and vice chairman, are generally floor members. The floor members control the important advisory committee, while the nominating committee, which in effect selects the elected members of the board of governors and the next nominating committee, has twice as many regular as allied members. An increasing number of specialists have served as governors, floor governors, and floor officials in recent years, and specialists with a limited amount of public business have been elected to the board of governors as partners of firms "engaged in a business involving direct contact with the public." The influence of the floor professionals was most clearly demonstrated by the adoption of the floor-oriented program of the Committee of 17 in 1949–50.

The seat concept has deep roots, reflecting the original private-club concept of the Exchange. It is only natural to think of those having a substantial investment in a seat as being proprietors and therefore holders of the franchise. Yet it is anomalous that voting power is so closely tied to floor participation that, on the one hand, a firm whose function involves floor operations—the prime example is an odd-lot firm—must have seats, i.e., votes, in proportion to its floor business, whereas, on the other hand, a firm whose business is with the public and primarily away from the floor may build a massive and farflung exchange business around a single or very few seats. The anomaly is emphasized by the fact that many seats held in the names of individual members are actually owned and controlled by their firms and that frequently the office partners of a member firm have a larger financial stake in the firm than the floor partners.

The floor has ceased to be a place where the most important members of the Exchange community trade with one another. The floor professionals—specialists, odd-lot dealers and brokers, and floor brokers—are not necessarily the most talented for administration or regulation or the most responsive to public needs, even though the nature of their operations requires them to own seats and to be at the Exchange during the working day. Office partners located in New

York or in offices throughout the country may be more sensitive to the public character of the Exchange and more cognizant of the needs of public investors, even though they have fewer seats and little occasion to be in the actual marketplace. In light of this, it would seem that full or partial voting rights should be extended to allied members; i.e., partners or voting stockholders of member firms. Also, the composition of the governing bodies of the Exchange should be altered to give increased representation to firms without specialist affiliation doing business directly with the public.

In most respects, the organizational structure of the Exchange as a self-regulatory agency seems basically sound. The reforms recommended by the Conway Committee in 1938 and adopted by the Exchange have proved to be effective on the whole. Policymaking authority is properly vested in the board of governors which is also the repository of regulatory power.

The chairman of the board, who is required to be a regular member and is invariably a floor member, plays an important part in the disciplinary mechanism of the Exchange. Apart from his board membership he is also a member of the informal committee, which screens major disciplinary cases before they are referred to the board. In addition, the chairman has special responsibilities in supervising floor conduct and is considered "chief on the floor."

The president is the Exchange's chief executive officer and its official representative in all public matters. The full-time staff is responsible for administering the Exchange and is generally of adequate size and quality. With regard to regulation of members' and member firms' conduct off the floor, the staff has sufficient authority and responsibility to carry out its regulatory duties. The regulation of conduct on the floor is complicated, however, by the existence of the floor governors, who resemble in material respects the standing committees who governed the Exchange prior to the adoption of the reforms recommended by the Conway Committee. Because the floor governors are considered to be the experts on floor matters, there has been a tendency for the staff and even the board to defer to the judgment of the floor governors or an individual floor governor in resolving specific questions, and the authority and responsibility of the staff with regard to floor matters have tended to be limited accordingly. The recent action of the Exchange in giving the Floor Department greater authority in floor regulation should be followed by additional steps in the same direction, so that the role of the Floor Department in this area will be equivalent to that of the Department of Member Firms in off-floor regulation.

As already indicated, there is a great diversity in the Exchange's initiative and effectiveness in taking hold of different kinds of regulatory problems. To mention a few examples at the high end of the scale: In respect of the all-important matter of qualifications of those entering the securities business, its contribution has been of a high order. The administration of its net capital rule has been generally vigorous and resourceful. Its promulgation and enforcement of controls relating to listed companies, such as periodic financial reports, proxy solicitation, and timely disclosure, have significantly contributed to increased investor protection, and it also took the initiative in establishing and enforcing standards in the area of underwriters' compensation.

On the other hand, its leadership has been much less noticeable and its accomplishments much less noteworthy in respect of selling and advisory practices. Until recently it seems to have devoted little attention to selling practices and supervision by its member firms of their branch offices despite disturbing evidence that serious abuses were occurring. The concept of suitability was largely subsumed under the "know your customer" rule, where emphasis has traditionally been on protection of firms rather than of customers. And at least until recently its concern with market letters and investment advice has been focused more on questions of good taste than on the qualifications and standards of research departments of its member firms. Moves recently undertaken by the Exchange to strengthen its programs in these areas are no less welcome for being belated, but great opportunities remain.

A different kind of illustration of the Exchange's failure to exercise regulatory initiative is described in chapter VI.E in connection with odd-lot trading on the Exchange. Although two member firms dominate this important aspect of the exchange market and the Exchange acknowledges it has full power to regulate such trading, this power has not been exercised in the last 25 years.[1]

The surveillance techniques employed by the Exchange likewise differ widely. The visitation program of Exchange examiners is an excellent factfinding mechanism and an effective means of detecting irregularities, particularly those related to net capital and other areas where books and records are themselves revealing. On the other hand, its surveillance techniques in respect of market letters and selling activities and of its members' supervision in these areas have been minimal. Only recently has it begun to pay close attention to conduct in branch offices.

Another surveillance technique, stock watching, is a pioneering effort by the Exchange in utilizing automation to detect market irregularities. The stock watching procedure should become increasingly sophisticated as the Exchange's automation program advances. Nevertheless, the Exchange has not been as resourceful in adapting automation to the surveillance of member conduct on the floor. As presently constituted, floor surveillance is an arduous and time-consuming task with the final product subject to numerous inaccuracies because of the volume of statistics involved. Increased use of automation might result in more accurate data and permit the staff to devote less time to clerical duties and more to analysis of the subtle and complex problems involved in floor regulation.

With regard to the regulation of specialists, the Exchange's efforts have been intensive and systematic within the limits of its own concepts, yet they have been inadequate in total effect. They have tended to be mechanical and generalized, and have failed to focus adequately on concrete problems, such as the applicability of the specialist's conflicts of interest in specific instances, and disparate performances among specialists. The fact that responsible officials of the Exchange were unaware that two-thirds of its specialists were accepting "not-held" orders for many years in violation of law is an indication of the limits of its program. The facts that inaccuracies in floor trading reports have gone undetected, that late filings have been tolerated, and

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[1] Similarly, the Commission has not exercised its authority under sec. 11 of the Exchange Act to regulate odd-lot trading.

that repeated violations have been disposed of without disciplinary sanctions, are further examples.

A significant limitation in the Exchange's self-regulatory functioning is its handling of public complaints involving its member firms. Instead of using this source of information to advantage as an important tool of self-regulation, the Exchange has performed essentially a buffering function. Complaints of serious impact have gone uninvestigated, while complaining customers have been led to believe that an investigation had been made when this was not the case. Furthermore, in contrast to its professed impartiality in such matters, the Exchange's responses have occasionally been made in such a manner as to strengthen the member's defense. It is to be hoped that the recent changes adopted by the Exchange in the handling of these complaints will result in more effective utilization of them as a surveillance device.

Related to the handling of public complaints is the Exchange's arbitration machinery. It appears to operate efficiently and fairly—indeed, with respect to the machinery itself, geographic expansion to make it more conveniently available to customers throughout the country would seem desirable. The arbitration machinery should not, however, operate as a substitute for, or a limitation on, the Exchange's exercise of its own disciplinary responsibilities where the serious import of a complaint indicates the need for investigation and action by the Exchange itself.

In the disciplinary area—the handling of revealed violations—the Exchange leans toward tenderness rather than severity, but with some unevenness in respect of different types of violations. The Exchange appears more willing to impose severe disciplinary sanctions where the interests of its membership are directly at stake, such as cases involving enforcement of the minimum commission schedule, than where violations involve ethical standards in dealing with customers, such as supervision of salesmen or trading against advice given in a market letter. Admonitions and censures ("severe" or otherwise) are often the extent of punishment meted out, even for substantial infractions; an illustration is the Exchange's recent disposition of a disciplinary matter involving massive violations of its gratuities rule by a leading member.

Related to the above, as cause or effect, is the high degree of informality and privacy surrounding Exchange disciplinary proceedings. It may be argued that, under the theory of self-regulation, these qualities, or at least the former, are preferable to their opposites, but it is still a question of drawing lines. Unlike the case of the NASD, where the Exchange Act expressly provides for certain formalities in disciplinary cases, there is no statutory provision applicable to exchanges. In practice the NYSE does not hold formal hearings except in proceedings before the board. In rendering disciplinary decisions the board of governors and the advisory committee do not write opinions containing either findings of fact or reasons for the decision.[2] The member or allied member is not entitled to be represented by counsel. Registered representatives are subject to a more summary procedure, although the Exchange has recently adopted changes designed to make these proceedings more closely parallel those involving members. The

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[2] Of the disciplinary cases handled by the Exchange during 1957–61, approximately 70 percent were decided by the advisory committee.

Supreme Court has recently emphasized the crucial significance of fair procedures in self-regulatory actions affecting nonmembers and it would seem that similar considerations might broadly apply to cases affecting registered representatives, applicants for membership, and members.[3]

The Exchange's policy regarding publicity of disciplinary actions may be assumed to be attributable, at least in part, to a natural reluctance to publish anything adverse about any of its members. Also, publicity about a sanction imposed may itself constitute an additional sanction. These considerations must be balanced, however, against the public's interest in the conduct or misconduct of firms or persons with whom it deals and in the integrity of a public marketplace. As a general principle, with such general or specific exceptions as the Commission may approve, Exchange disciplinary actions resulting in the imposition of a penalty by the advisory committee or the board of governors should be publicly reported.

In the background of many of the Exchange's self-regulatory activities is its interest in public relations. Basically three elements are involved, promotion of share ownership by an ever-larger segment of the public, informing potential investors about securities and securities markets and counselling them about good investment practices, and advertising the quality of the Exchange's market and its member firms. The more that the Exchange does to encourage share ownership by "little" investors, who tend to be new and unsophisticated investors, the greater its obligation to provide rules and practices that are actually in accord with the needs of such investors, and the greater also its obligation to avoid exaggerations and misunderstandings of what the actualities are.

While it would be unfair to suggest that the Exchange has been unmindful of its substantive obligations to the people it invites to deal with its member firms in its market, in recent years it appears to have been disproportionately concerned with the image of itself and its members that it projects. A good example is in the area of research and investment advice as discussed in chapter III.C; the Exchange has devoted very little attention to the research capacity of its member firms but considerable attention to assisting them in advertising that capacity. Similarly, the Exchange misses few opportunities to praise its specialists as a group but does miss many opportunities to improve the performance of individual specialists whom the praises do not fit.

Even if the publicity were always justified by the facts, it may be open to question whether advertising the quality of its market and member firms is wholly compatible with the Exchange's statutory role as self-regulator. From the point of view of the public interest, the best that can be said for this emphasis is that competition among markets is beneficial and this publicity is a superficial form of competition. It would seem, however, that this role might more fittingly be performed by the members themselves, through their Association of Stock Exchange Firms,[4] for example. In its role as self-regulator the Exchange stands in the shoes of the government itself, and must have an appropriate degree of aloofness from those it is regulating. To be sure, the very concept of self-regulation involves a merging

[3] See ch. XII.I (pt. 4).
[4] For a discussion of the activities of this organization, see ch. XII.H (pt. 4).

of regulator and regulatee, but nevertheless the effectiveness of self-regulation is certain to be dulled where the same individuals who are responsible for policing an organization and elevating its practices and standards are simultaneously concerned with advertising how good it already is.

The Special Study concludes and recommends:

1. The influence and prestige of the New York Stock Exchange and the importance of its membership in all sectors of the securities business have provided it with a unique opportunity and responsibility as a self-regulatory agency. Fittingly, it has been foremost among self-regulators in the breadth of its activities, and in many areas it has provided vigorous leadership and produced excellent results. Its record, nevertheless, is an uneven one. Although it has viewed its regulatory role broadly, it has fallen considerably short of its own best levels of achievement in many specific areas critically affecting the public, both in formulating rules and standards to meet changing needs and circumstances and also in providing effective enforcement of its rules and standards. Other chapters, particularly chapters II, III, and VI, contain substantive conclusions and recommendations pertinent to the Exchange's role as self-regulator. The following are confined to the organizational and procedural aspects of this role.

2. A disproportionate influence of floor professionals in the government of the Exchange stems ultimately from the concept of "seats" and the allocation of voting power in the Exchange constitution, since only the holder of a seat ("regular" member) may vote in elections or on constitutional changes. This should be corrected by extending full or partial voting rights to allied members. In addition, the composition of the board of governors, advisory committee, nominating committee, and other governing bodies of the Exchange should be altered to give increased representation to firms without specialist affiliation doing business directly with the public.

3. In respect of floor regulation the role of the floor department of the staff should be strengthened in relation to the floor governors. In particular, its investigatory authority and responsibility should be expanded in the manner of the department of member firms in respect of off-floor regulation. Specific actions taken by a member on the authority of a floor governor should be regularly reported to the floor department.

4. The enforcement and surveillance techniques of the Exchange range from highly effective ones to quite inadequate ones. Through expansion of the present use of automation or otherwise, more significant and sensitive techniques of surveillance of members' conformity with rules and standards applicable to floor activities can and should be developed, along lines recommended in chapter VI. As to off-floor activities, the Exchange's programs for surveillance of market letters, selling activities, and members' supervision of branch offices should receive early and substantial attention, along lines recommended in chapter III.

5. The Exchange's handling of customers' complaints against member firms should be reoriented. Complaints of serious import should occasion serious investigation of facts, to determine

whether disciplinary action is warranted. In cases of this kind, the Exchange should act in a self-regulatory role and not in a protective role toward its members; it has recently made moves in this direction. The Exchange's arbitration machinery, generally efficient and fair though it appears to be, should not be used as a substitute for or in derogation of the Exchange's exercise of its disciplinary responsibilities.

6. For self-regulation to be effective the Exchange should impose punishments that fit the infractions involved, particularly those involving ethical standards in dealing with the public, where marked leniency has sometimes been shown. While formality in disciplinary matters should not be sought for its own sake, there should be enough of it to provide basic fairness and also to assure adequate accountability at all levels of the self-regulatory process. As a general principle, with such general or specific exceptions as the Commission may approve, disciplinary matters resulting in the imposition of a penalty by the advisory committee or the board of governors should be publicly reported; staff-imposed sanctions should be periodically reported to the Commission.

7. The Exchange's program of encouraging widespread investment in listed securities by the general public entails a heavy responsibility to see that its own rules and standards and the practices of its members are in keeping with reasonable protection of unsophisticated investors. The Exchange's public relations efforts directed toward informing potential investors about securities markets and counseling them about good investment practices should be continued or even increased, as should its publication of significant economic and statistical data. On the other hand, public relations efforts directed toward emphasizing the merits of the Exchange's mechanisms or members are not wholly compatible with the Exchange's self-regulatory role and should be left to individual members or their unofficial organizations.

PART C. THE AMERICAN STOCK EXCHANGE AS A SELF-REGULATORY INSTITUTION

The picture revealed at the American Stock Exchange prior to January 1962 was a complete distortion of the self-regulatory system embodied in the Exchange Act. The "general deficiency of standards" and "fundamental failure of controls" noted in the staff report required prompt and drastic remedial action for the protection of the public interest.

During 1962 the Exchange made major moves in the direction of establishing a regulatory system sufficient to meet its responsibilities under the act. A new management, committed to establishing and enforcing high standards of commercial honor and integrity, assumed control of the Exchange's government. A new constitution was put into effect embodying provisions aimed at providing responsible self-government. The standing committee system was discarded and a staff system of administering the Exchange was substituted. Stricter listing and delisting standards were adopted, and existing specialist controls were strengthened. Disciplinary action was taken against members who were found to have violated Exchange rules and Federal law.

The Exchange has thus undergone a major constitutional and organizational reform. 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.

PART D. THE MIDWEST STOCK EXCHANGE AS A SELF-REGULATORY INSTITUTION

As one of the largest regional exchanges, the Midwest Stock Exchange occupies an important position in the securities markets with the potential for an expanded role in future years.[5] In assessing the MSE's self-regulatory performance it should be emphasized that its regulatory efforts are directed principally at sole members and securities traded only on that Exchange. The MSE does not examine firms that are also members of the NYSE, and it leaves market surveillance of dually traded stocks to the primary market.

The government of the MSE is vested in the board of governors; the executive committee performs board functions between board meetings. The Exchange's organizational structure also includes regional and standing committees; the regional committees represent the cities whose exchanges were merged into the MSE, and the standing committees have regulatory and other responsibilities in specified substantive areas.

The Exchange staff plays a crucial role in the administration of the MSE and in regulating member conduct, again highlighting the importance of a paid staff, with sufficient authority and responsibility, to accomplish effective self-regulation. The important role played by the MSE president in the Exchange's disciplinary machinery and in its total administration contributes to the efficient performance of the Exchange's role as a self-regulatory agency.

The impact of the public advisers on MSE affairs appears to be minimal, thus giving the appearance of public representation in Exchange affairs more than the actual fact. The public advisers rarely attend board meetings, do not have the right to vote at these meetings, and are more involved in matters of listing than in the regulatory process.

The MSE has taken leadership in various significant ways including qualification examinations for members, centralized automated bookkeeping for member firms, and clearance of transactions by mail. Its self-regulatory program devotes considerable effort to the enforcement of its net capital rule, but seemingly inadequate attention to the supervision of member firm selling practices.

The Special Study concludes and recommends:

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

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[5] See ch. VIII.E (pt. 2).

such recommendations or adaptations as may be found appropriate.

2. The Exchange should undertake a reassessment of the institution of public advisors to determine whether it can become a more effective instrument for representation of the public in Exchange affairs.

PART E. THE PACIFIC COAST STOCK EXCHANGE AS A SELF-REGULATORY INSTITUTION

The Pacific Coast Stock Exchange is important as a securities market because of its present business and its potential for future growth. As with the Midwest Stock Exchange, some of the larger NYSE commission firms are also members of the PCSE and a substantial percentage of trading on the PCSE take place in securities that are also listed on one of the New York exchanges. The primary thrust of the PCSE's regulatory effort is directed at sole members and securities traded only on that exchange.

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

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

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

Experience has demonstrated that, in an exchange of substantial size, this kind of arrangement is of less than maximum effectiveness and has within it the potential for abuse. The reforms adopted by the NYSE in 1938 and those adopted by the Amex in 1962 incorporated the concept of a paid staff with the authority to operate the exchange. The report of the Levy Committee, the industry group that studied the Amex, concluded that the standing committee system, among other things, resulted in an absence of well-defined responsibility and the assumption by the committees of greater powers than

the president or the board, and was an obstacle in the development of necessary staff initiative. A reorganization of the PCSE in the direction taken by other important exchanges seems highly desirable in light of their experience.

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

The Special Study concludes and recommends:

1. The PCSE, under the supervision of the Commission, should undertake a thorough examination of its organizational structure with a view to providing a paid staff of adequate size and authority for self-regulatory functioning in lieu of the present reliance on a committee system.

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

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

PART F. THE OTHER EXCHANGES AS SELF-REGULATORY INSTITUTIONS

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

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

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

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

Part G. The NASD as a Self-Regulatory Institution

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

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

Over the years, the NASD's policies and rules have multiplied and now deal with many aspects of the securities business. In enforcing its standards of conduct, the association makes over 1,700 special and routine examinations of its members annually, covering a wide variety of subjects relating to the business of its members, and it institutes more than 450 formal complaint proceedings in a year. It also engages in various other activities of a regulatory nature, such as review of underwriting compensation and mutual fund selling literature. Another significant function of the NASD, outside of the strictly regulatory sphere, is the dissemination of retail quotations.

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

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

The latter area is a uniquely difficult one in both quantity and quality. Its uniqueness stems from the fact that the association is virtually

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

At all levels, although staff assistance is used, hearing and decision is by members, i.e., part-time volunteers serving this and other needs of the organization. At the district level this has produced severe strains, delays and compromises. At the national level it threatens a breakdown in the capacity of the organization to act promptly and—an even more serious problem—its capacity to deal adequately with important questions of policy and program. There is now such preoccupation with disciplinary matters, in addition to matters of internal administration, that little time is left for the top governing officials to perceive and solve large questions.[6]

"Time" is the key word, the time of volunteer members. There are limits on the amount of time that any individual in the securities business can afford to devote to association affairs. The chairman is called upon to make the greatest sacrifice, and the demands of the office have been such that, even apart from other reasons, a single 1-year term has been the pattern. The demands on other members of the board of governors are obviously less and they have 3-year terms, but here another limitation applies: the organization is nationwide and the board has nationwide representation. Thus it is necessary to assemble the governors from their several places of business in order for them to meet as a board. In recent years this has occurred three times a year, for 3 days at a time, a total of 9 meeting days annually.

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

As the organization has grown and its business has expanded, the association has endeavored to keep pace by bringing more individual members into active participation in its affairs, especially at the district

[6] For example, in 1962 the board decided 115 disciplinary cases, 75 of which had been appealed by respondents and 40 of which had been called up by the National Business Conduct Committee. In that year, the association closed a total of 486 cases. See ch. XII, G, 3.b(2)(b) (pt. 4).

level. But this has increased the responsibilities imposed on an already inadequate staff. The essentially unsolved—and gradually worsening—problem of the NASD is to find a mode of functioning effectively while not unduly sacrificing its emphasis on the "self" in self-regulation. The solution of this problem, it is believed, will require substantial rethinking as to (1) the composition and role of the full-time staff in relation to the role of the volunteer officials, and also as to (2) the alloaction of responsibilities among volunteer member participants.

(1) With regard to the composition and role of the full-time staff, it is pertinent to refer briefly to the NYSE. The NYSE and the NASD obviously are not comparable institutions, yet in their strictly self-regulatory aspects comparison is not completely out of order. Some indication of the difference in their equipment is the Stock Exchange's staff of some 226 individuals engaged primarily in regulatory activities, headed by a full-time president, an executive vice president, 8 vice presidents and 9 directors of departments, as against the NASD staff of some 130 full-time employees headed by an executive director and his assistant, 3 secretaries of members' committees, a house counsel, and 14 district secretaries.[7]

It is obvious from these facts alone that the NASD's conception of the role of a staff in the self-regulatory process is quite different from that of the Stock Exchange. It must also be concluded, without any criticism of individuals making up the staff, that the NASD version is inadequate except on a theory that the staff's role should be minimal, both in quantity and in responsibility, as compared to that of volunteer officials. As early as 1938, the NYSE went over to a system that deemphasized the role of member committees and increased the role of the permanent staff, headed by a full-time president as chief executive officer. The Amex has made similar changes in slower stages, the latest occurring in 1962 and still in process. The Midwest Stock Exchange has had a full-time president for some years. It seems obvious that the time has come, if it has not been long overdue, for the NASD to have an executive staff of adequate numbers and with adequate delegation of responsibilities. Only in this way can there be found any real hope for carrying the workload, in view of the inherent limitations on the time that can be devoted by members actually engaged in business. Moreover, only in this way is there any chance of assuring the continuity of program and administration that cannot be achieved through volunteer part-time officials elected in 1-year or 3-year cycles.

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

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

to which the latter would be devoting greater attention than at present.

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

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

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

Secondly, the role of "substantive" committees, such as the Quotations Committee or the Investment Companies Committee, should be clarified and their liaison with the board of governors strengthened. On the one hand, delegation of responsibility to permanent or ad hoc committees is essential if complex and time-consuming questions of policy are to receive attention beyond what the board as a whole can give them. On the other hand, such committees should act as arms

of the full board and subject to its overall direction and coordination. As in the case of the business conduct committee, the chairman and/or part of the membership of each such committee should be board members, but presumably most members would be from outside the board, by election or appointment. Staff assistancce should be made available as needed by each committee, but again under the overall direction of the heads of staff so as to assure efficient integration of separate areas of interest into the total self-regulatory effort. Very likely there would be other aspects of the association's work, not now dealt with through committees, for which this general pattern of member committees with staff assistance would be a useful one.

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

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

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

While the conduct of disciplinary proceedings has been generally fair, certain policies and practices have tended to inhibit their effectiveness as a remedial tool. In addition to problems brought about by

the increasing delays in disposing of cases, their corrective value appears to have been noticeably impaired (at least until recently) by restrictive policies toward publication of results, while disparity in the penalties assessed against violators may raise questions of fairness in particular instances.

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

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

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

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

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

The Special Study concludes and recommends:

1. The NASD's job of self-regulation is a peculiarly difficult one, involving as it does a unique combination of these factors, among others: (a) Its membership is very large and not preselected— it is compelled to open its doors to all qualified persons, and the

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

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

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

4. Without limiting the concept of self-regulation by members themselves, but rather in furtherance of that concept, the NASD's paid staff should be increased in size, stature, and responsibility. The office of executive director should be upgraded to that of president and he should be made a voting member of the board and some or all of its standing committees. With adequate assistance of vice presidents and department heads, he should have responsibility for continuous administration by the entire staff, both in national and district offices, subject to the overall direction and control of the board of governors. To further these objectives, consideration might be given to granting tenure for a limited period of years to a holder of the office, as in the case of

some of the stock exchanges. The staff should have a larger role in all enforcement and disciplinary activities, both for the purpose of assuring systematic and consistent attention to surveillance and enforcement of established rules and policies and for the purpose of relieving volunteer members of routine burdens of enforcement and discipline until the stage of actual decision of individual cases. The staff should also be equipped, available, and utilized to conduct studies or otherwise assist elected officials and member committees in formulating policies and programs of self-regulation on a continuing basis.

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

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

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

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

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

PART H. CERTAIN QUASI-SELF-REGULATORY ORGANIZATIONS

A number of associations of persons and firms in the securities business perform, or purport to perform, self-regulatory functions in addition to trade association activities. The measure of control which these

organizations exercise over their members varies considerably. Some, such as the Investment Company Institute and the Association of Mutual Fund Plan Sponsors, Inc., have promulgated codes of business ethics, although they have not established any surveillance or enforcement machinery.

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

The survey of the limited number of organizations just given is sufficient to indicate that, even where they have significant regulatory purposes, they largely lack programs for making them effective and, under the doctrine of *Silver* v. *New York Stock Exchange*,[8] might run afoul of antitrust policy if they attempted to enforce certain types of regulation without statutory sanction or official review of their action. In any event, they cannot be considered as providing a satisfactory source of self-regulation or substitute for regulation in areas where regulation is deemed necessary in the public interest or for the protection of investors.

Ideally, official self-regulation should be extended to include all elements of the securities business that feasibly can be included; recommendations have been made accordingly in chapters II, III, IV, and XI in relation to mutual fund selling organizations, distributors of and dealers in real estate securities, investment advisers, and others not now subsumed under an existing self-regulatory organization.[9]

PART I. SELF-REGULATION AND THE COMMISSION

Because self-regulation is such an important and integral part of the regulatory pattern for the securities markets, and because the Commission at the same time has powers of direct regulation and responsibilities of oversight over self-regulation, a study of the adequacy of the rules of self-regulatory agencies finally involves an inquiry into the Commission's role in relation to those agencies. An appraisal of that role, in turn, compels analysis of the scope and limits of the self-regulatory concept itself, in theory and in practice.

Self-regulation as a part of the total regulatory pattern of the securities industry involves certain advantages that have been recognized since the concept was first introduced. The expertness and immediacy of self-regulation often provide the most expedient and practical means for regulation. By making those regulated actual participants in the regulatory process they become more aware of the goals

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[8] 373 U.S. 341 (1963). The *Silver* case is discussed in ch. XII.I (pt. 4).

[9] The Commission's 1963 legislative program, designed to carry out these recommendations, includes a proposal to make membership in a registered securities association mandatory for broker-dealers doing an over-the-counter securities business. See S. 1642 and H.R. 6789 (also No. 6793), 88th Cong., 1st sess. (1963).

of regulation and their own stake in it. In some areas the self-regulatory bodies can promote adherence to ethical standards beyond those which could be established as a matter of law.

On the other hand, self-regulation inherently has certain disadvantages and limitations as compared with governmental regulation, the most obvious of which was early identified as the "weakness of human nature." Thus, self-interest on the part of the regulators may result in complacency concerning matters of public concern, leniency in imposing sanctions, or a desire to avoid adverse publicity for the business being regulated. Furthermore, self-regulation presents its own problems of practicality and efficiency, not unlike those of direct governmental regulation.

Certain fundamental concepts concerning the relationship between the self-regulatory institutions and the Government stem from the fact that, in important respects, the self-regulatory body is an official arm or delegate of governmental power. The crucial function of public oversight, vested by Congress in the Commission, involves assuring that the delegated powers are exercised effectively and not in a manner inimical to the public interest.

The need for assuring that self-regulation is effective applies in all areas of the regulatory process—rulemaking, surveillance, and enforcement. Governmental authority—from the outset described as "a big stick" or as a "shotgun * * * well oiled [and] ready for use"—is held in reserve to assure that each regulatory need is met fully and effectively. This applies both in those areas where the Commission is given authority to regulate directly but has deferred to self-regulatory agencies and those where the Commission is authorized to review and modify self-regulatory rules.

The problem of assuring that there is no misuse of the power delegated to the self-regulatory organizations is well illustrated in the recent Supreme Court case of *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963). In that case the Court decided that the Exchange was liable to the plaintiff broker-dealer under the Sherman Antitrust Act for causing its members to discontinue their wire connections with him. The Court stated that the difficult problem of the case arose from the need to reconcile the policy of the antitrust laws with the policy of encouraging self-regulation, which could have anticompetitive effects in application. Because of the absence of a review power in the Commission to insure that an exchange's enforcement of its rules is not arbitrary and does not injure competition without "furthering legitimate self-regulative ends" the Court thought it proper for an antitrust court to perform this function. The opinion expressly left open the question of application of the antitrust laws in those areas where the Commission has a review power over self-regulatory actions, as under the Maloney Act in respect of disciplinary proceedings of the NASD.

Another important area of governmental oversight involves those aspects of the self-regulatory organizations' activities which resemble those of public utilities. An exchange's setting of uniform commission rates and the NASD's operation of a retail quotation system are examples of such activities, as are programs for automation of market mechanisms.

Although governmental oversight of self-regulation is essential, the workability of self-regulation depends also on restraint in the Com-

mission's exercise of its reserve power. The relationship between the Commission and the self-regulatory organizations has at times been referred to as a "partnership" or "cooperative regulation." Under either expression the roles of the Commission and the self-regulatory agencies are essentially complementary, and the self-regulatory agencies must enjoy such autonomy as will enable them to act as responsible, dynamic partners in a cooperative enterprise.

The statutory provisions of the Exchange Act establishing the relationships between the Commission and the stock exchanges and between the Commission and the NASD are broadly similar but also exhibit marked differences. The latter are attributable to differences in the natures and historical backgrounds of the two types of organizations and to the fact that the two sets of provisions were not enacted together but with a few years' interval. Both groups of statutory provisions, sections 6, 11, and 19 for the exchanges, and section 15A for the NASD, require that the self-regulatory organizations register with the Commission and that the Commission not permit their registration unless their rules meet certain requirements. Some of the major differences between the two sets of provisions are that the Commission is expressly given power to amend exchange rules dealing with substantive matters of regulation while in the case of the NASD it is given that power only concerning organizational matters; that exchanges are not required to file rule changes with the Commission before they become effective while the NASD must file in advance; and that the Commission does not have express power to review exchanges' disciplinary proceedings but has that power in the case of the NASD.

The Commission also has certain direct rulemaking powers in regard to practices on the exchanges (secs. 10 and 11) and in the over-the-counter markets (sec. 15). The Commission has never adopted rules under section 11, but has chosen instead to suggest the adoption of pertinent rules by the exchanges themselves.

With reference to the Commission's role of oversight toward the exchanges, the most pressing question today is that arising out of the *Silver* case, in relation to exchange enforcement and disciplinary matters. The *Silver* case pointed out the need to assure, through outside review, that what is done in the name of self-regulation is genuinely such and is not inimical to other aspects of the public interest. In the absence of Commission review, the antitrust court was found to be the appropriate forum. It is the belief of the Special Study that if self-regulation is to function effectively and with due regard for all aspects of the public interest, including the interest in vigorous self-regulation, the forum for review of self-regulatory action should be the agency already established as the official, expert guardian of the public interest in the field of securities, i.e., the Commission.

In the absence of provisions for formal Commission review the exchanges have followed varied practices in reporting their disciplinary actions to the Commission. The Commission has not established an effective system of regular surveillance of the exchanges' enforcement and disciplinary activities. In general, it has equipped itself, in personnel and procedures, only for the more passive role of surveying whatever is brought to its attention through reporting systems established, perhaps years ago, with the various exchanges.

To prevent recurrence of the kind of self-regulatory breakdown that took place on the Amex in recent years, the Commission must reexamine and strengthen its total concept and program for surveillance and oversight of self-regulatory discipline. In general the strengthening of its program should include more direct and continuous awareness of actual happenings in the market place, stronger and more continuous liaison with each exchange as to its self-regulatory problems, policies, and methods, and fuller and more systematic accounting by the exchanges as to their self-regulatory progress and results. The question of self-regulatory responsibilities and procedures in connection with violations of the Securities Act of 1933 should be the subject of separate attention.

A further important question is whether the Commission itself should be empowered to enforce self-regulatory rules, particularly in those areas where the Commission has direct authority under the Exchange Act to make and enforce its own rules but instead has allowed the exchanges to adopt rules as part of their self-regulatory activities. While it appears that a regulatory pattern of reliance on self-regulation with effective governmental oversight should logically include such a power, no recommendation to this end is made at this time since it cannot be said that the Commission has found its existing powers insufficient in this respect.

As indicated, the Exchange Act does not require exchanges to file rule changes prior to adoption. The NYSE in 1956 formally agreed to give the Commission notice of material changes at least 2 weeks before public announcement, except in "unusual circumstances." For the past year, moreover, both the NYSE and the Amex have followed the practice of discussing proposed rule changes with the Commission staff prior to submitting them to their respective boards of governors. The regional exchanges generally do not discuss rule changes in advance, but merely file them pursuant to the statute after adoption. For rules of importance to the public interest or for the protection of investors, the Commission's present arrangements and procedures for review do not seem sufficient to assure the needed continuous oversight on the Commission's part. The most obviously needed change is to provide for filing of all proposed rules with an adequate interval before effectiveness, as is now required in the case of NASD rules.

Unlike the situation with respect to exchanges, the Commission has authority to review NASD disciplinary actions. Resembling the situation with the exchanges, however, the Commission has no program for broadly or systematically surveying the operation of the NASD disciplinary system—from the point of view of its total effectiveness or conformity with statutory objectives.

Since NASD rule changes are required to be filed in advance and may be disapproved by the Commission before effectiveness, the Commission's staff, and often the Commission itself, reviews and analyzes them substantively to a greater degree than is necessarily true of exchanges' rule changes. However, the Commission has no program for regular or systematic review of existing NASD rules or policies, nor has it fully made use of its experience gained from its review of registration statements or from its enforcement activities as a guide to oversight of NASD rules and policies.

The Commission's total role under the Securities Act of 1933 and the Securities Exchange Act of 1934 may be broadly divided into two main categories: (1) Administering disclosure requirements for issuers, and (2) regulating conduct in the securities markets, directly or by supervision of self-regulation. As a broad generalization it appears that the Commission has been more successful in exercising its powers and responsibilities in the former area than in the latter. While efforts have been very productively devoted to enforcement of the laws and regulations through administrative, injunctive, and criminal proceedings against violators, it appears to the Special Study that an insufficient portion of the attention and energies of the Commission and its staff in the postwar years have been devoted to other important responsibilities such as continuous examination of changing market circumstances and regulatory needs, appraisal and reappraisal of the adequacy of the existing regulatory measures, and evaluation and oversight of the operation of the self-regulatory organizations. Although the Commission's Division of Trading and Exchanges is one of the most important of its operating divisions and has been manned by persons of great competence and dedication, it does not appear to have been adequately staffed or organized to fulfill its potential and necessary role in respect of the types of responsibilities mentioned.

In addition to placing stronger emphasis on its responsibilities in the area of regulation and supervision of self-regulation, the Commission should, to a greater extent than has been its practice, publicly record the substantive results of its administration of regulatory and supervisory powers. Actions or policy determinations of importance, even though not reflected in formal decisions, should be more regularly recorded for the information of the public and the Congress and for the guidance of the industry, the self-regulatory bodies and future members of the Commission and its staff.

The Special Study concludes and recommends:

1. Regulation in the field of securities should continue to be based on the principle of giving maximum scope to self-regulation, wherever and to the extent that a regulatory need can be satisfactorily met through self-regulation. As a corollary, it is an essential role of government, i.e., the Commission, to assure that there is no gap between the total regulatory need and the quantity and quality of self-regulation provided by the recognized agencies. However broad or narrow this gap may be in particular areas, or at particular times, governmental power and performance must be sufficient to assure that the self-regulatory agencies are performing in the manner and degree expected of them and that direct regulation is available and effective where a self-regulatory agency is unwilling or unable to fulfill a reguatory need. Governmental participation is necessary also to assure that action taken in the name of self-regulation fairly serves a valid public purpose and is not for a purpose inimical to antitrust or other public policies; and conversely, that bona fide self-regulatory action is not inhibited because of a risk of liability in the absence of Commission review (cf. *Silver* v. *New York Stock Exchange*). While the Commission must have ample powers to accomplish