these purposes, as more particularly set forth in the following paragraphs, they should continue to be regarded essentially as residual powers, to be exercised as needed but in such manner as to allow maximum initiative and responsibility to the self-regulators. Regulation in the area of securities should, in short, be a cooperative effort, with the government fostering maximum self-regulatory responsibility, overseeing its exercise, and standing ready to regulate directly where and as circumstances may require.

2. In the present statutory scheme there are marked differences between the provisions defining the Commission's powers in respect to exchanges (particularly secs. 6, 11, and 19 of the Exchange Act) and those applicable in respect of the NASD and any other "national securities associations" (sec. 15A). These differences may in part reflect differences in the origins and natures of the two types of agencies, and may in part reflect the time interval of several years in the enactment of the two sets of provisions. In any event reexamination of these differences and of related Commission responsibilities is now warranted in light of subsequent experience and developments, including the *Silver* decision. In this reexamination the principles set forth in paragraph 1, that there should be maximum reliance on self-regulation but with ample governmental power in reserve, should apply.

3. In respect of rules (in the broadest sense) of the self-regulatory agencies, it is one of the important continuing responsibilities of the Commission to examine them upon initial promulgation and to reexamine them from time to time in light of changing circumstances. To provide reasonable opportunity for examination of exchange rules prior to their initial effectiveness, the pattern now applicable to the NASD, calling for 30-day advance filing and Commission power to disapprove before effectiveness (sec. 15A (j)), should be made generally applicable to rules of exchanges, with appropriate provision for longer or shorter intervals to be established in respect of particular types of rules or in special circumstances. As recommended in paragraph 7, the Commission should be equipped in personnel and program to make adequate preeffective study of new rules and to maintain general oversight over the existing bodies of rules in changing circumstances.

4. The present statutory pattern applicable to exchanges, under which the Commission has comprehensive power to adopt its own rules as to major substantive matters (secs. 10 and 11) and to amend or supplement exchanges' rules as to other matters to assure fair dealing and protection of investors (sec. 19(b)), has no direct counterpart in respect of over-the-counter markets. The Commission does have very considerable substantive rule-making power under section 15(c), but has no authority to amend or supplement NASD rules on substantive matters. The Special Study has been unable fully to explore the legal question of the potential scope of section 15(c) in relation to the scope of possible regulatory needs and objectives. Further study of this question should be undertaken promptly and, if and to the extent such study indicates that the section 15(c) powers are insufficiently

broad in these respects, the regulatory gap should be closed through legislation giving the Commission the necessary direct rulemaking power or, alternatively, the power to amend or supplement an association's rules.

5. In respect of disciplinary proceedings, minimum requirements of "due process" should be applicable to proceedings of exchanges that may result in denial of membership or employment or in imposition of fines, suspensions or expulsions of members or employees, or that may affect the right of specific nonmembers to do business with members. It may be possible to accomplish this without statutory amendment by voluntary exchange action or by the exercise of the Commission's power under section 19(b) (as suggested by the Supreme Court in *Silver,* footnote 16 to majority opinion) or alternatively under section 23. In the same manner, or by statutory amendment if necessary, another imperative need indicated by the *Silver* decision, but extending beyond the facts of that case, should be met promptly: to provide for Commission review of at least certain types of exchange disciplinary matters in the manner now applicable to associations (sec. 15A(g)).

6. Consistent with giving maximum scope to self-regulation (par. 1) and avoiding duplication in the total regulatory effort so far as possible (see ch. XII.J (pt. 4)), the Commission should seek to reorient its own regulatory effort in respect of trading and markets, as rapidly as circumstances justify, in the direction of reducing its direct participation in areas that are, or can and should become, adequately covered by self-regulation, e.g., periodic examinations of books and records of broker-dealers, and giving greater emphasis to (i) continuous oversight of the self-regulatory performance of exchanges and national securities associations in all areas in which reliance is placed upon them, (ii) regulation of such exchanges and associations in areas where they themselves are operating in a quasi-public-utility capacity, e.g., in their own operation of market mechanisms, (iii) enforcement proceedings in areas that self-regulation cannot or does not effectively reach, including Securities Act cases, cases involving novel and important issues, cases involving persons other than or in addition to members of self-regulatory bodies, cases involving need for subpoenas and/or the need for immediate injunctive action, and cases of a serious or flagrant nature involving fraud or manipulation or in which criminal prosecution is indicated, and (iv) enunciation of rules and standards of conduct arising out of its continuing awareness of market developments and its enforcement experience.

7. The Commission's Division of Trading and Exchanges, perhaps renamed "Division of Trading and Markets," should be enlarged and strengthened in keeping with the foregoing. It should be so organized and staffed that it will be in a position to maintain more effective liaison with all of the self-regulatory agencies, examine their rules and rule changes, keep informed as to their enforcement activities, and generally oversee and evaluate their performance on a continuous basis and advise the Commis-

sion with respect thereto. Its Branch of Economic Research should be expanded so that considerably greater emphasis can be given to compilation, analysis and, where appropriate, publication of data concerning important aspects and developments of the trading markets.

PART J. THE TOTAL REGULATORY BURDEN—THE NEED FOR INCREASED COORDINATION—THE ROLE OF THE STATES

The burden of securities regulation is borne by the various exchanges, the NASD, the Commission, and the States. Each of the bodies with regulatory duties is concerned with the conduct of those firms and individuals under its authority, and frequently this results in overlapping responsibilities and duplication of effort. Duplication and a lack of coordination of regulatory activity necessarily results in added costs and burdens to those firms with multiple memberships, which represent a substantial percentage of those doing business in the securities industry. From the point of view of the regulatory bodies themselves, overlap and lack of cooperation inevitably means that available personnel and resources are not utilized to achieve maximum performance.

Until recently, each of the self-regulatory agencies administered its entry and qualification requirements with little regard for the standards of the other bodies. In July 1963, three of the major institutions, the NASD, NYSE, and Amex, established a joint testing procedure for registered representatives. No such cooperative program has been undertaken, however, for the purpose of standardizing rules of conduct of various self-regulatory groups.

The examination program of some of the major regulatory bodies, which are extremely important detection devices, have been the subject of a limited amount of coordination. The NASD, the major exchanges, and the Commission have coordinated their examinations so that no broker-dealer is examined by more than one of them in a 6-month period, unless special problems exist. This program contributes to the elimination of the most obvious form of duplication. However, no efforts to standardize examination procedures or, until recently, to exchange information obtained through examinations have been made. Furthermore, until recently, none of these groups had given any significant amount of attention to branch office inspections.

The various self-regulatory bodies have pursued independent courses in connection with disciplinary matters. There has been little formal or informal communication among the groups as to investigations which are contemplated or in progress. Even the results of disciplinary actions have not been made available to interested agencies.

There is the further and more difficult question of which agency should pursue an investigation and punish the violator if the matter falls within the jurisdiction of more than one regulatory body. In practice, the answer may depend on the manner in which the violation came to light, the kinds of securities involved, the applicable standards of conduct, the investigatory power of the particular agency, its willingness to prosecute the matter, and the sanctions available to the respective agencies. It seems clear that stronger lines of communica-

tion between the different bodies would be desirable and that greater effort should be made to clarify responsibilities. Recent moves in this direction should be encouraged and the Commission should take the initiative in bringing interested agencies together to formulate appropriate guidelines.

There has been a recognition among industry leaders in recent months that a reduction in duplication and an increase in coordination can contribute to more effective regulation. Important cooperative steps have been taken by some of the agencies in respect of customer complaints, underwriters' compensation, financial responsibility, Regulation T enforcement, and qualification examinations for salesmen.

Despite the national character of most of the securities regulation discussed in this report, the States occupy an important position in the overall regulatory scheme. They provide a means of handling certain essentially local problems and they complement Federal regulation in important ways, although there is considerable variation in the scope and effectiveness of the regulatory activities of the various States. The activities of the State administrators, through the North American Securities Administrators and the Midwest Securities Commissioners Association, have been useful in developing higher standards in certain important substantive areas as well as in attempting to achieve uniformity of regulation among the States.

There appear to be successful cooperative programs for the exchange of information among the various States and between the States and the Commission. In some respects the self-regulatory agencies have cooperated with the States, particularly as to examinations for salesmen. However, a special problem appears to exist between the NASD and the States in that the NASD is unwilling to furnish information to State administrators regarding Association disciplinary actions. In the interest of strengthening the total regulatory effort it would be desirable to give local NASD officials broader discretion to cooperate and coordinate their disciplinary activities with State officials.

The Special Study concludes and recommends.

1. This report indicates various ways in which the quantity and quality of self-regulation and/or governmental regulation need strengthening. On the other hand, available mechanisms, budgets, and personnel of some agencies already seem overtaxed, and at the same time there appears to be considerable duplication of effort among the various agencies in certain respects, adding to the burdens on the agencies themselves and on broker-dealers subject to multiple regulation. In the interests of the public, the regulatory agencies and the securities industry, further and continuing attention should be given to possibilities for coordinating efforts and allocating responsibilities in a more efficient and productive pattern, without limitation on any self-regulatory agency's freedom to have special measures or programs for its own membership. Among such possibilities would be further standardization of application and report forms for firms and individuals, to be used by all interested agencies with appropriate supplementation by each to serve its special needs; further development of centralized examining and investigating procedures, again with appropriate supplementation to meet special needs of

each agency; coordination of efforts in defining standards of conduct in areas of common concern; clearer recognition of one agency or another as having primary enforcement responsibility in respect of particular categories of firms or subject matters; and stronger lines of communication among agencies to facilitate channeling of information relevant to the interests of each. In the Federal regulatory scheme, as recommended in paragraph 8 of part I, the Commission's role should involve greater emphasis on oversight of self-regulators and on regulatory matters that self-regulation cannot effectively reach, avoiding, so far as possible, direct duplication of effort with self-regulatory agencies. This will necessarily require the self-regulatory bodies to refer promptly to the Commission those disciplinary matters which they are unable to prosecute effectively.

CHAPTER XIII

THE MARKET BREAK OF MAY 1962

Shortly after the market break of May 28–31 the Special Study was asked to add to its agenda an examination of that important occurrence. Some of the results of its inquiry are reflected in other chapters (especially VI and VII) and a general summary is contained in this chapter. In view of the fact that the NYSE has published its own study [1] containing relevant aggregated data for the three particular days, the Special Study has sought to avoid duplication of that analysis. Instead it has attempted to take a somewhat wider look, by examining trading on 16 additional days, and at the same time a closer look, by studying specific stocks and disaggregated data.

In its analysis of the disaggregated data the study found that while there were general patterns of behavior, there were also striking departures from the overall picture. For example, odd-lot customers in the aggregate were net sellers on May 28, but they had a purchase balance in AT&T. The open-end investment companies studied, on the other hand, were overall net buyers of stocks on that day but were sellers on balance in General Motors and U.S. Steel and had no transactions in Avco or Brunswick. Similarly, although specialists as a group had a purchase balance, they were relatively large net sellers of Korvette and had modest sale balances in IBM and U. S. Steel. These variations in the practices of the participants in individual issues reveal the inadequacy of aggregated data alone to portray realistically the diversity of members' and nonmembers' transactions in individual stocks.

Neither this study nor that of the New York Stock Exchange was able to isolate and identify the "causes" of the market events of May 28, 29, and 31. There was some speculation at the time that these events might be the result of some conspiracy or deliberate misconduct. Upon the basis of the study's inquiry, there is no evidence whatsoever that the break was deliberately precipitated by any person or group or that there was any manipulation or illegal conduct in the functioning of the market.

The avalanche of orders which came into the market during this period subjected the market mechanisms to extraordinary strain, and in many respects they did not function in a normal way. Particularly significant were the lateness of the tape and the consequent inability of investors to predict accurately the prices at which market orders would be executed. Further indicative of the disruption of the trading mechanisms, some odd-lot orders on May 28 were not executed at the first round-lot sale following receipt as required, but at the day's closing price, in most instances considerably lower, plus or minus the odd-lot differential.

[1] NYSE, "The Stock Market Under Stress" (1963).

On the 3 days of the market break the percentage distribution for purchases and sales by types of orders [2] on the NYSE was as follows:

TABLE XIII–d.—*Distribution of types of orders on the NYSE, May 28, 29, and 31*

[Percent]

	Market	Limit	Stop
May 28, total	53.1	42.4	4.5
Purchases	35.4	64.1	.5
Sales	70.1	21.5	8.4
May 29, total	69.3	29.1	1.6
Purchases	64.5	34.6	.9
Sales	74.1	23.5	2.4
May 31, total	60.5	38.5	1.0
Purchases	68.2	31.3	.5
Sales	51.3	47.2	1.5

Source: NYSE, "The Stock Market Under Stress," p. 37 (1963).

It is noteworthy that on May 28, 70.1 percent of public sell orders were market orders and another 8.4 percent were stop orders, whereas 21.5 percent were limit orders. On the buy side, on the other hand, 64.1 percent were limit orders, and 35.9 percent market and stop orders. Since May 29 was characterized by a continuation of the sharp decline during the earlier part of the day and a very sharp recovery in the later part of the day, and since it was not possible to allocate orders between these two phases, significant relationships in terms of types of orders could not be established. On May 31, however, when prices moved sharply upward, there was a distinct reversal of the pattern from that of Monday: on the purchase side 68.7 percent of orders were market and stop orders, whereas on the sell side only 52.8 percent were market and stop orders.

The relatively large volume of sell-stop orders on May 28 is also worthy of note. As already mentioned, such an order is used as a protective measure to assure a prompt sale if the market price reaches or falls below a previously specified figure, and it becomes a market order when that price is reached. Thus, a sharp decline such as that of May 28, already involving a heavy preponderance of market sell orders as compared with buy orders, produces a separate source of market orders as stop orders are triggered by the decline. The sell-stop orders held by specialists on May 28 may not have been entered on that day; some may well have been placed at any time previously and have come into play as prices fell.

The "snowballing" effect of stop orders on May 28 was pointed out by a specialist who testified:

* * * the book was heavy with stop orders, and they, as much as anything, were responsible for the decline, with an overhanging volume of market short

[2] Three main types of orders are used to buy or sell securities in the auction market of the NYSE: market orders, limit orders, and stop orders. Briefly, a market order is one to buy or sell at the best price available. A limit order is one to buy or sell at a specific price or better; on the sell side the specified price would be above the prevailing market, and on the buy side, below the prevailing market. A stop order, sometimes called a "stoploss" order, specifies a price at which, if the market moves adversely, the customer desires an execution. If the order is on the sell side, it specifies a price below that prevailing; on the buy side, a price above that prevailing—the reverse of the situation in limit orders. It does not, however, guarantee execution at the specified price, but merely becomes a market order if and when that price is reached. It is to be expected that the volume of sell-stop orders would ordinarily exceed that of buy-stop orders.

orders. The bid had to be dropped considerably to take care of the new stop orders that were put into effect * * *.

The volume of short selling in the aggregate, and for certain individual stocks, by classes of participants, is shown elsewhere in the report,[3] but these figures do not necessarily reveal the full impact of short selling. In testimony taken by the study, specialists indicated that there was a significant amount of potential short selling (brokers in the "crowd" waiting for an uptick) which was never realized in transactions. This potential short selling overhanging the market may well have prompted some specialists to moderate their stabilizing activities, since they would know that any rally would be met by short-sale orders in the "crowd." As one specialist put it, short selling during the break acted to "lengthen the time that it took a stock to go up because there had to be substantially more buyers to move the stock up. * * *"

The Exchange Act makes it clear that there is an important public interest in the effects of rapid price fluctuations both up and down. The Act states as one of the reasons for its passage the fact that "national emergencies * * * are precipitated, intensified, and prolonged by * * * sudden and unreasonable fluctuations of security prices and by excessive speculation. * * *"[4] Accordingly, the Commission is given the authority and responsibility—

if in its opinion the public interest so requires, summarily to suspend trading in any registered security on any national securities exchange for a period not exceeding 10 days, or with the approval of the President, summarily to suspend all trading on any national securities exchange for a period not exceeding 90 days.

The power to suspend all trading on an exchange is indeed an awesome one, as indicated by the requirement of Presidential approval, and the Commission has never invoked it. Once market changes became so chaotic as to warrant halting all trading on the exchanges, it is possible that investor tensions would be so acute that unexpected and severe reactions might follow from the suspension itself.

On the other hand, assuming that any intermediate, technical measures—i.e., measures short of suspension of all trading—would be feasible and desirable, it obviously is not practicable to wait until a severe break is in progress to determine what they may be. The uncertainties and pressures existing under such conditions militate against the development of a sound course of action. Nor is it possible at the time of a market break, unless arrangements for gathering information have been worked out in advance, to obtain speedily the kind of current and meaningful trading data which the Commission and other Government agencies might consider useful in discharging their responsibilities. Yet, once a break has passed, there is a tendency to forget the concerns existing at the time and the apprehensions as to what might happen should it continue.

The history of the May 28 market break reveals that a complex interaction of causes and effects—including rational and emotional motivations as well as a variety of mechanisms and pressures—may suddenly create a downward spiral of great velocity and force. This, in turn, may change the impact of various normal market mechanisms,

[3] Ch. VI.H.5.b. (pt. 2).
[4] Exchange Act, sec. 2(4).

and thus temporarily impair the market's fair and orderly character. Where the latter situation prevails, a public interest in orderly markets, quite distinguishable from any public intervention in the setting of price levels, may come into play.

The question thus arises whether it would be desirable and feasible for the Commission and the industry jointly to formulate programs for exchanging information and/or for the taking of intermediate, technical steps—short of suspension of trading—that would be designed to provide market conditions as orderly as possible in a period of stress, even though they could not, of course, be expected to alter major market trends. The Special Study is of the view that, whether or not such programs would ultimately be found practicable or desirable, the question is one deserving further exploration.[5] Any program of intermediate measures that might be evolved would presumably contemplate action to be taken primarily by the industry as distinguished from the Commission, which would remain essentially in the role of overseer of self-regulatory action.

It would be unrealistic and indeed illusory to believe that the narrow and technical powers possessed by the Commission itself could ever prevent basic price changes. The Commission's role is primarily regulatory, not economic. Traditionally and consistently, it has exercised its powers in such manner as to avoid dealing with price levels or permitting any misconception that it was dealing with price levels. Nothing in this chapter is intended to suggest a change in this role in the direction of "managing" price movements or purposefully affecting prices.

The NYSE is already endeavoring to develop improved equipment which should greatly ameliorate the problems arising from tape lateness. The implementation of various specific recommendations made elsewhere in the report, in part upon the basis of data relating to the market break, with respect to such matters as short selling, the capital position of specialists, floor trading and odd-lot transactions, should also tend to improve the ability of Exchange mechanisms to function more effectively in times of stress. The study being made by the Division of Trading and Exchanges with respect to stop orders should contribute to this effort.

The Special Study concludes and recommends:

Neither the Study nor the NYSE has been able to ascertain the precipitating "causes" of the May 1962 market break. However, analysis of disaggregated market data has permitted identification of certain specific factors in the operation of market mechanisms that may have accentuated its severity. At most, any

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[5] After war was declared in September 1939, lines of direct communication to important sources of information in the financial community were established and liaison with the national securities exchanges was developed:

"Through its machinery for gathering as much information as possible, it kept constant scrutiny over the volume and trend of orders as they came into the leading brokerage offices before those orders reached the floor. Each morning before the markets opened the Commission and its experts were in contact with its sources of information to find out the character and size of the brokerage orders which had accumulated overnight. It kept track of the effect of market changes upon margin accounts. It received current reports on the size of short positions and the condition of the books of the specialists in various leading stocks on the floors of the various exchanges. It was able, in cooperation with the New York Stock Exchange, the Treasury, and certain houses specializing in foreign dealings, to judge the trend and volume of foreign transactions." S.E.C., 6th Annual Report, p. 89 (1940).

Similar steps were taken on later occasions such as at the time of President Eisenhower's heart attack.

measures that might be taken with reference to such factors could only be addressed to ameliorating their impact. The Commission's role is to promote an orderly market and not to affect fundamental economic forces or price trends. The following recommendation must be viewed in this context.

The Commission and representatives of the industry, particularly the exchanges, should make a joint study of possible intermediate measures, short of suspending trading, that might be invoked to assure minimum disruption of the fair and orderly functioning of the securities markets in times of severe market stress. While the Special Study has not undertaken to evaluate the possibilities, the types of intermediate measures to be considered might include such things as limitations on short selling (see ch. VI.H, recommendation 3), special provisions in respect of the handling of stop sell orders or market sell orders, and temporary interruption of trading in individual securities under predefined circumstances. It is possible that the implications of such actions could be tested in advance through the use of simulation techniques on a computer. There should also be Commission-industry consultation with a view to collecting certain crucial types of trading information that might be helpful in connection with possible application of any of such intermediate measures or that might be useful in times of market stress to other governmental agencies having wider economic responsibilities.

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SUPPLEMENT TO PART V OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION

Consisting of

LETTER OF APRIL 5, 1963, FROM OREN HARRIS, THE CHAIRMAN OF THE INTERSTATE AND FOREIGN COMMERCE COMMITTEE, HOUSE OF REPRESENTATIVES

LETTERS OF APRIL 19, JULY 23, AND AUGUST 8, 1963, FROM THE CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

PREFACE

This supplement contains a letter from Oren Harris, Chairman of the Interstate and Foreign Commerce Committee, House of Representatives, requesting an indication of the position of the Securities and Exchange Commission with respect to the conclusions and recommendation set forth in the Report of the Special Study of Securities Markets. This supplement also contains the letters of the Securities and Exchange Commission, responding to the request from Chairman Harris.

LETTER

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
Washington, D.C., April 5, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission, Washington, D.C.

DEAR CHAIRMAN CARY: I am sure that you appreciate that our committee cannot but be impressed with the manner in which you have undertaken the assignment which the Congress placed upon you nearly 2 years ago to undertake a study of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations. Your presentation to the Subcommittee on Commerce and Finance, Wednesday afternoon, was helpful in an understanding of the magnitude of the task and of the nature of the reports which you are furnishing to the Congress.

I think it appropriate that you furnish the Congress with the results of the study and investigation as carried on by your Special Study Group inasmuch as any study of the character such as is this necessarily involves a consideration of the role which the Commission itself has played during the years being examined. On the other hand, the resolution does direct the Commission itself to report on its own recommendations to the Congress and the record in this specific regard seems a bit ambiguous.

I note that in the five chapters prepared by the Special Study Group which you have submitted as the first segment of your complete report each has a summary section containing conclusions and recommendations of the Study Group. In some chapters this appears at the end of the chapter whereas in others this summary is under different sections of the chapter. (It is understood that when you have completed all of the chapters, you have the thought of pulling together these summaries of conclusions and recommendations into one volume).

It appears to me, accordingly, in the light of the language of section 19(d) and of the discussion before the Subcommittee last Wednesday, that it might be appropriate for you to indicate to us as to each of these recommendations which:

(1) You have adopted as your own as set forth in your transmittal letter;

(2) You have designated as the subject of the Commission's rule-making process (as you indicated Wednesday you had initiated through letters addressed to industry representatives requesting them to create advisory committees for such consideration); and

(3) You are holding in abeyance for further consideration as to treatment in either of the ways above or possible rejection in their entirety.

Sincerely yours.

OREN HARRIS,
Member of Congress, Chairman.

LETTER

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 19, 1963.

Hon. OREN HARRIS,
House of Representatives,

DEAR MR. HARRIS: I appreciate your letter of April 5, and your generous comments with respect to the Report of the Special Study of Securities Markets—the first segment of which we submitted to you on April 3. You point out that Public Law 87–196 directs the Commission itself to report to the Congress on its own recommendations, and it might be appropriate for the Commission to indicate its views as to the specific recommendations already made by Special Study.

May I say first of all that we stand strongly behind the Report of the Special Study, as indicated in our letter of transmittal. With some reservations as to Part D of chapter III and Parts B and C of chapter IV—which we are holding in abeyance—we accept all the general recommendations made in the chapters of the Special Study which were submitted to you (chapters I–IV and IX). We are exceedingly fortunate to have assembled such a superlative group from private law practice, the universities, and the Commission staff to conduct this study. The report will be the most comprehensive of its kind in over 25 years and should be the keystone for regulatory and industry action.

The major objective of our letter of transmittal was to emphasize the legislative proposals and to report to Congress the principal ones which we hope to submit at the earliest possible time. We are keenly aware of your admonition to have these presented promptly, and further believe them to be an essential ingredient of investor protection and a prerequisite for further action, including rulemaking. Accordingly, we are now concentrating our efforts on drafting detailed statutory proposals and explanatory materials. At the same time, we shall over the next 6 weeks devote our attention to examining the balance of the report which has been promised by the end of May. For these reasons we are not yet focussing upon the exercise of rulemaking power, which is involved in numerous areas covered by the report.

After the legislation has been considered and the whole report submitted, we shall direct our attention to the rules recommended by the Special Study—which require appropriate submission to the public under the Administrative Procedure Act—and to other recommendations which will necessitate joint efforts with the industry. In certain areas, of course, we cannot provide immediate answers. As the Special Study's letter of transmittal to the Commission indicates, it would be impossible for the Special Study (or for the Commission) to propose "complete or final" answers to all the questions which they have posed. Indeed, "for some of the most knotty there is merely an indication of the possible approaches . . . that may point the way to future solutions."

As you will note, many of these recommendations consist of a statement of an objective to be attained, together with suggestions as to possible methods of accomplishing it, either by rules or policies of the Commission or by rules or policies of self-regulatory agencies. As the report of the Special Study recognizes, there are many instances where further exploration of alternatives is necessary to select the best method of accomplishing a specified end, and it may be that the method ultimately selected may differ to some extent from that recommended by the Special Study.

Moving now to the specific suggestion in your letter, we shall attempt to indicate as to each of the recommendations of the study those which we have adopted as appropriate for legislation, those we have designated as the subject of Commission rulemaking process, and those we shall hold in abeyance for further consideration (whether legislative or rulemaking).

CHAPTER II. QUALIFICATION OF PERSONS IN THE SECURITIES INDUSTRY

We are in agreement with all 12 conclusions and recommendations. They are an attempt to develop standards of character, competence, and financial responsibility and are the basis of legislative proposals, with three exceptions (items 3, 11, and 12) which can be handled under our rulemaking authority. With respect to items 11 and 12 relating to net capital requirements, the Commission will also provide in the legislative proposals that the self-regulatory organizations may have the same power with respect to financial responsibility as they would have with respect to character and competence.

CHAPTER III, PART B. SELLING PRACTICES

We are in agreement with all seven conclusions and recommendations. Only item 7 involves a legislative proposal, which was included in our letter of transmittal. This would provide the Commission with

more flexible sanctions and the power to focus disciplinary action upon individual salesmen and branches.

Many of the recommendations in III, B are of a general nature which will require continuous development, achieved in large part through discussion with the industry, through action of the self-regulatory agencies, and in some particulars through the exercise of rulemaking power. The improvements suggested relate to supervision over selling practices, development in surveillance and enforcement procedures and in existing concepts of suitability, availability of information to customers, and modes of compensating salesmen.

Item 3 of the recommendations involving selling practices falls most clearly within our rulemaking power and would require designation of retail transactions as solicited or unsolicited, filing of customer complaints, and information as to the investment goals of the customer.

CHAPTER III, PART C. RESEARCH AND INVESTMENT ADVICE

We are in agreement with all five recommendations and conclusions. The fifth is a legislative proposal, i.e., that registered investment advisers other than broker-dealers should be organized into an official self-regulatory association. We are still exploring the way in which it can best be achieved.

Items 2 and 4 in our opinion can be handled by rule. Item 2, relating to the content of market letters and investment advisory materials, would require disclosures of sources of information, research techniques, existing positions in stocks recommended, persons responsible for the preparation of market letters, and other matters. Item 4 in effect would prohibit reckless dissemination of written investment advice.

The other conclusions and recommendations (items 1 and 3), generally discouraging indiscriminate advertising of research and advisory facilities, and recommending the strengthening of market letter surveillance, are directed to the self-regulatory agencies. We shall make every effort to foster action on their part.

CHAPTER III, PART D. PROTECTION OF CUSTOMERS' FUNDS AND SECURITIES

We accept the underlying principles, but wish to hold in abeyance the last four of the five conclusions and recommendations. The first, suggesting a reserve in cash or Government bonds of some part of the free credit balances, can be carried out under our rulemaking authority. Some additional time and attention, however, will have to be devoted to the exact mode of carrying it out. Items 2, 3, and 5 are interrelated proposals and technical in nature. We would prefer to bring them to Congress at a later date. Item 4 calls for further study.

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CHAPTER III, PART E. DELIVERY OF SECURITIES

We agree with the four conclusions and recommendations, which are addressed in large part to the industry and self-regulatory institutions. We shall lend our support in seeing that they are carefully considered.

CHAPTER III, PART F. THE BROKER DEALER AS CORPORATE DIRECTOR

This is a general rather than a specific recommendation which we and the self-regulatory organizations should pursue.

CHAPTER IV. PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC. PART B. NEW ISSUES

We are generally in agreement with most of the conclusions and recommendations, but wish to hold in abeyance, for further study, parts of items 2 and 3. The first item is a general conclusion rather than a recommendation and we accept it as a preamble to the recommendations which follow.

The second is a series of proposals for rulemaking which are intended to eliminate or temper certain factors which contributed to the "hot issue" market of 1961 and early 1962. We feel that subrecommendations (a) and (b) relating to allotments of securities can and should be adopted but believe the balance; i.e., (c), (d) and (e), warrant further consideration. The third item (conditioning acceleration upon delivery of a prospectus or offering circular in substantially final form to any recipient of an original allotment 2 days before sales are made) raises a considerable number of problems and hence falls within the group held in abeyance.

We agree with the fourth item extending the requirement of delivery of prospectuses from 40 to 90 days in the case of new issues and have incorporated this within our legislative proposals for registered securities. We believe the same principle can be applied to Regulation A offerings by rule.

As to the fifth item, we agree with the conclusions that the NASD should strengthen its enforcement of the prohibition against free-riding and withholding, but the mechanics of achieving this will have to be considered further.

With respect to items 6 (review of underwriting arrangements) and 7 (relating to options, warrants or "cheap stock" in public offerings), we are in full agreement and shall take such action as is required by us and sponsor appropriate action by the NASD.

We agree with item 8 that the Commission should take appropriate steps to clarify the application of rule 10(b)(6) and shall take the necessary action.

CHAPTER IV, PART C. UNREGISTERED DISTRIBUTIONS

This part has three recommendations. We accept in principle the concept of notifying the Commission of these types of distributions for the purposes of information and enforcement. However, with respect to both the balance of the first recommendation and also the second one, we are inclined to hold them in abeyance for further consideration.

The third item is merely a reference back to earlier material in Part C on which we have already expressed agreement.

CHAPTER IV, PART D. THE INTRASTATE EXEMPTION

We agree with the objective. The proposal to have advance notice of offerings filed with the Commission has been achieved in part by a recent rule of the NASD requiring a similar notification from its members. We shall hold in abeyance any decision as to how much further we should go beyond the action which the NASD has taken.

CHAPTER IV, PART E. REAL ESTATE SECURITIES

We have already adopted the recommendation that all distributors of and dealers in securities (including real estate securities) should be required to be members of a registered securities association. As previously noted, we are proposing legislation along those lines. The second item is a suggestion for further study of the problems in this field—which have been a continuing object of our consideration.

CHAPTER IV, PART F. INTEGRATION WITH PREVIOUS FILINGS

The integration of disclosure requirements under the Securities Act and the Exchange Act is a long-term program and warrants serious thought, but the final objective can only be achieved in gradual steps. Sometime ago we instituted a short-form registration statement with respect to debt securities (S–9) and we shall now undertake a second step, the preparation of a comparable short-form for certain equity securities on the basis discussed in the first conclusion and recommendation.

In connection with the first two paragraphs of the second item, we have been reevaluating the scope and content of our present reporting and proxy requirements and of our examining procedures.

We concur with the last paragraph of the second item that the waiting period for short-form filings should be kept to a minimum and have put this into effect. We are also seeking legislative authority to reduce in our discretion the time period during which dealers are required to deliver prospectuses.

CHAPTER IX. OBLIGATIONS OF ISSUERS OF PUBLICLY HELD SECURITIES. PART B. PROTECTIONS FOR INVESTORS IN LISTED AND UNLISTED SECURITIES

Chapter IX relates to extension of disclosure through reporting requirements and proxy statements and of the insider trading provisions to a large number of companies—whose securities are traded over-the-counter. There are eight recommendations in part B. We have adopted them all but one and have embodied them in our legislative proposals wherever necessary. We shall hold in abeyance item 7(c), amending section 16(b). In addition to the recommendation of the Special Study, we shall offer these related proposals: first, authorizing the Commission to suspend trading of an over-the-counter security; second, requiring the filing of material contracts upon the registration of a security; and third, obligating a company to distribute to its stockholders information similar to proxy material where proxies have not been solicited.

Item 8 is a general approach with which we agree, and we shall explore the economic and technical problems involving the feasibility of increasing dissemination and use of filed information.

CHAPTER IX, PART C. CORPORATE PUBLICITY AND PUBLIC RELATIONS

There are three recommendations in part C. They meet with our general agreement. Item 1 recommends that stock exchanges and the NASDA should establish high standards for the dissemination of corporate publicity, and we shall take steps to encourage this proposal. Based upon the recommendation in item 2, we shall propose a statute designed to prohibit false and misleading corporate publicity. We did not include this in our letter of transmittal because our views had not yet crystallized.

Item 3 concerning the disclosure of compensation paid to public relation counselors or firms meets with our full accord and is within our rulemaking power.

* * * * * * *

I believe this makes explicit our views with respect to all the recommendations made by the Special Study to date. As we indicated in the initial paragraphs of this letter, we are proceeding now with our legislative proposals and shall subsequently consider the exercise of our rulemaking authority. It should be recognized that many of the recommendations of the Special Study were directed at encouraging action on the part of the self-regulatory institutions. Although in full accord, we would point out that at the present time our statutory powers to achieve these improvements are limited. Much, of course, can be carried out on the initative of the Exchanges and the NASD, but it is our belief that as a program of self-regulation is fostered and expanded, correspondingly broader powers of oversight are needed.

Although we have not had the benefit of the final conclusions of the Special Study on the role of self-regulatory institutions, the chapters already submitted inevitably call for their increased participation in the regulatory system. At the same time it has become clear that our power to alter and supplement the rules of the NASD is more limited than our power in connection with the exchanges. This unevenness is unwarranted, particularly in the light of the NASD's growing responsibilities. Accordingly, we are proposing as part of our legislative program some limited extension of oversight over the NASD so that it may be available if the public interest should require.

A copy of this letter is being sent to the Chairman of the Senate Banking and Currency Committee.

Faithfully yours.

WILLIAM L. CARY,
Chairman.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 23, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives.

DEAR MR. HARRIS: As you are aware, on July 17, 1963, the Commission transmitted to the Congress the second installment of the Report of the Special Study of Securities Markets. In our letter of transmittal we indicated that we would shortly submit a more detailed response to the recommendations of the Special Study and that is the function of this letter. We recognize that the Congress expects such a response as evidenced by a letter from you, dated April 5, 1963, requesting our views with respect to the specific recommendations contained in the first part of the report.

We noted in our transmittal letter that we accept this report as a responsible springboard for rulemaking proposals and discussions with the industry. We further emphasized certain considerations serving as a background to any detailed responses by us to the recommendations, which we repeat here.

First, the second installment of the report contains recommendations designed to be carried out by the Commission under its rulemaking power and by the self-regulatory agencies. Accordingly, it is inappropriate for us to speak definitively on various of the questions presented which involve substantive changes in our rules and the rules of the self-regulatory agencies. In most cases we are required to solicit and consider the views of interested persons before making any final decisions. Moreover, we believe that the responsible course of action calls for discussions with the securities industry before defini-

tive actions are taken. In the second place, we note that the problems disclosed in the report are subtle and complex; many are just emerging and many call for further study. Finally, we point out that, although our legislative program—embodied in H.R. 6789, 6793, and S. 1642—is part of a general effort to raise standards in the securities markets, the program stands by itself; thus, consideration of the bills can appropriately proceed independently of the discussion and resolution of the questions raised in the chapters just transmitted.

With these considerations in mind, we turn to the specific recommendations. As we did in our letter of April 19, 1963, in answer to your request with regard to the first part of the report, we shall note those recommendations we have adopted as appropriate for legislation (only one), those we have designated as the subject of rulemaking, and those we shall hold in abeyance for further consideration (whether legislation or rulemaking). We would repeat here what we stated in that letter; namely, that many of the recommendations consist of a statement of objectives to be attained, together with suggestions as to possible ways of achieving them, either by rules or policies of the Commission, or of the self-regulatory agencies. It may be that the method ultimately selected will differ from that recommended by the study.

Chapter V is introductory and contains no recommendations.

CHAPTER VI. EXCHANGE MARKETS

Parts A through C are introductory.

Part D. Specialists

Item 1 is introductory to the remaining recommendations and indicates their applicability primarily to the New York and American Stock Exchanges. With respect to items 2 and 3, we agree that a Commission rule concerning the dealer functions of specialists should be considered which would define, on the one hand, responsibilities and on the other restrictions upon trading. With respect to item 4, we agree with the need for higher capital requirements for specialists on the New York Stock Exchange. We also concur with item 5 which calls upon the exchanges to refine the obligations of specialists generally treated in items 2 and 3.

With respect to item 6, we accept the principle that all securities in which a specialist is registered should be maintained in a single trading account.

With respect to item 7, we agree that the exchanges should undertake steps to refine the obligations of specialists as brokers and clarify various related floor procedures. As to item 7(f), we agree that specialists should be prohibited from servicing public customers. We believe that the Commission and the exchanges should consider

whether the association of a specialist with a firm having public customers calls for remedial action.

We agree with item 8, calling for further reports by specialists and recommending that they be made public. As to item 9, we accept the recommendation for further studies relating to the capacity of specialists to acquire larger blocks of stock. We agree with item 10 which calls for further protections and certain reports respecting the financial position of specialists. We also agree that additional surveillance techniques regarding specialist performance should be developed in accordance with the recommendations contained in item 11.

E. Odd-Lot Dealers

We agree with the recommendations of the Special Study relating to odd-lot activities.

F. Floor Traders

As to item 1, in light of the very serious and basic problems presented by the continuation of floor trading, as brought out by the report of the Special Study and as evidenced by prior studies, and of the lengthy and apparently unsuccessful efforts to resolve them, the Commission agrees that a rule proposal abolishing floor trading on the New York and American Stock Exchanges should be developed, unless those exchanges demonstrate that its continuance would be consistent with the public interest.

We believe studies on the possibility of "auxiliary specialists" should be undertaken as suggested in item 2.

We accept the recommendation in item 3 that separate consideration should be given to the problem of floor trading on the regional exchanges.

G. Members' Off-Floor Trading

We agree with the one item in this part.

H. Short Selling

We concur with item 1 that more refined and complete information as to short selling transactions is needed, and with item 2 recommending a reexamination of procedures with respect to the reporting of "short-exempt" transactions. In respect of item 3, we agree that there is a need for a rule of broader perspective to provide a more effective regulatory control over short selling in a security when its market is under selling pressure.

I. Commission Rates

With respect to item 1, the Commission agrees that it should address more positive and continuous attention to the commission rate structure of the New York Stock Exchange. We accept the sugges-

tions that studies should be made concerning: arrangements for discounts for nonmember broker-dealers (item 2); volume discounts (item 3); and the feasibility and desirability of separate schedules for the brokerage and service components of commission rates (item 4).

As to items 5 and 6, the Commission recognizes that the problems involved in regulating commission rates in the securities business are far more intricate and intangible than those involved in public utility rate regulation, but that it would be desirable, to the extent possible, that the Commission's role in the rate-fixing process be more clearly articulated. The Commission agrees that the development of additional data and allocation formulae will also facilitate determination of the extent to which the establishment of objective standards for measuring the reasonableness of commission rates is feasible and useful.

With regard to item 7, the Commission will consider the adequacy of its arrangements with the New York Stock Exchange—developed at the time of the last commission rate increase in 1958—for supplying advance notice and information with respect to proposed increases.

We agree with the recommendation contained in item 8 regarding separate disclosure of the odd-lot differential and the brokerage commission in confirmations of odd-lot transactions.

J. Automation—Its Needs and Possibilities

With respect to the items in this section, the Commission agrees that the impact of automation on its operations and on the operations of the exchanges and of the member firms should be the subject of continuing study.

CHAPTER VII. OVER-THE-COUNTER MARKET

The Study has presented a series of conclusions and recommendations with respect to the over-the-counter market. One of these, relating to establishing appropriate controls over quotations systems, would require legislative action (item 1). We have already indicated our agreement that an amendment to the Exchange Act should be developed to achieve this purpose. It is believed that substantially all of the remaining items could be the subject of rulemaking by the Commission or the National Association of Securities Dealers.

The Commission agrees that a number of the practices discussed in this chapter appear inimical to the public interest and require additional or better controls, and that these matters should be considered promptly by the NASD and the Commission in terms of seeking effective corrective measures. Among these are included such items as the integrity of wholesale quotations (items 2, 3(a), and 3(b)); the development and dissemination of rules or policy directives relat-

ing to the obligations of broker-dealers to exercise diligence in seeking "best executions" of customers' orders (item 6); the formulation of rules or guides governing the proper methods to be followed, disclosures to be made, and the fairness of rates charged in the execution of various types of so-called "riskless transactions" (item 7); and the clarification, refinement, and fostering of better understanding of the NASD markup policy as it should be applied in various situations, giving appropriate recognition to the varying problems and policies applicable to broker-dealers performing differing roles in the wholesale and retail markets (item 8).

The Commission agrees also that it would be desirable for the NASD to continue its efforts to improve and strengthen its methods of handling "local quotations" and to endeavor to improve the information content of its retail-quotations system along the lines indicated in items 10, 11, and 12. From a longer range point of view, as proposed in item 14, it is of course essential that developments in automation be understood and its potential for improving the flow of information about the over-the-counter market be recognized and appropriately applied. As to item 15, we are prepared to consider with the NASD the feasibility of establishing a reporting system. We shall take into account the effect of any proposals on the third market (item 16). Finally we shall consider, with the NASD, the subjects raised in item 5.

The foregoing represent aspects of the over-the-counter markets as they have evolved and now exist which are among those pointed to by the Special Study as problem areas which call for reassessment by the NASD and the Commission. It is clear that proper solutions to these, together with action to be taken pursuant to recommendations in other chapters and enactment of the pending legislative proposals, should improve significantly, and promote better understanding of, the operation of the over-the-counter markets.

The remaining recommendations, namely, all or parts of items 3(c), 4, 9, and 13, call for exploration, study or action with respect to new regulatory concepts which could be expected to change, in some respects quite drastically, the existing methods for pricing securities in over-the-counter retail transactions and the operating procedures which have evolved in the conduct of that market. The Commission is not prepared, on the basis of the work so far done, to determine which of these concepts, if any, should replace those so far applied in the discharge of our obligations under the Act. Certainly, at this juncture, it would be impossible for the Commission to judge with assurance or certainty what the ultimate and total effect some of these suggestions might have upon the markets and the broad and essential functions they perform. We view these subjects as appropriate for

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discussions with our staff and with industry. Out of these, there may develop substantial changes, accelerated by the assistance of rapidly developing technology, in market procedures and in the quantity and dependability of information quickly available to the market place concerning the volume and prices of securities transactions in the over-the-counter market.

CHAPTER VIII. TRADING MARKETS—INTERRELATIONSHIPS

B. The Basic Allocation Between Exchanges and Over-the-Counter (as Primary Markets)

In respect of item 1, we agree that the listing and delisting standards of the exchanges should be reexamined.

We agree, as suggested by item 2, that a government-industry study of the feasibility and desirability of reducing the round-lot unit for all or some securities should be undertaken in the near future.

C. Institutional Participation and Block Transactions

With regard to item 1, the Commission agrees that it is important to obtain an adequate body of information about institutional securities transactions on a continuous basis.

Item 2 is held in abeyance and subject to discussion with the Department of Labor which administers the Federal Welfare and Pension Plans Disclosure Act.

With respect to item 3, we agree that the trading practices of institutions should be taken into account in any study of the commission rate structure, previously noted in connection with the recommendations in chapter VI, part I.

D. Over-the-Counter Markets in Exchange-Listed Securities

With regard to item 1, the study has pointed out the increasing importance of the so-called "third market" and, upon the basis of the evidence before it, has concluded that, under existing circumstances, this market is on balance beneficial to the public interest. This conclusion calls for no action by the Commission. The Commission recognizes, however, that other recommendations of the study call upon it to undertake further studies and analyses, primarily relating to the Commission rate structure of the New York Stock Exchange, which may result in proposals which could alter the conditions under which the third market operates and in other ways have an impact upon it.

As to items 2, 3, 5, and 6, the Commission agrees that additional data concerning the third market is necessary on a continuous basis. The exact content and amount of this data will be determined after further review and consultation with the affected persons.

As to item 4, our comments on item 7 in chapter VII are equally applicable here.

E. Allocation Among Exchanges—The Regional Exchanges as Primary and Secondary Markets

Item 1 represents an introductory approach to the problem of the regional exchanges with which we generally agree.

With respect to item 2, we agree that in any study of the commission rate structure, previously noted in connection with the recommendations in chapter VI, part I, due regard should be given to the potential impact of any proposals on the regional exchanges.

We agree with the Study's conclusion in item 3 that the survival of regional exchanges as primary markets would appear to be in the public interest. The steps to be taken, and the methods by which these ends can be achieved, must be worked out in conjunction with the exchanges. In the course of considering these steps, the Commission and the exchanges can consider whether, and to what extent, the specific recommendations in items 4 and 5 can and should be carried out.

F. General Considerations

With respect to items 1, 2, and 3, we agree that the accumulation and analyses of data with respect to the trading markets is desirable on a more continuous basis. We have already moved in this direction and have established an Office of Program Planning to assist in such a program. The content and quantity of the required data will be determined in the light of the recommendations of our new Office and of our operating divisions, and after consultations with the industry.

* * * * * * *

I believe this makes explicit our views with respect to the recommendations made by the Special Study in the second installment of the report. We anticipate that the final installment of the report will be submitted to Congress in the near future.

This letter is also being sent to the Chairman of the Senate Committee on Banking and Currency.

Sincerely yours.

WILLIAM L. CARY,
Chairman.

LETTER

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

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

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

I

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

II

The chapters here submitted deal with diverse subjects, including the adequancy of the structures and practices of the self-regulatory agencies, security credit regulation, mutual fund selling practices, and events surrounding the market break of May 1962. As in the case of prior sections of the report, the Special Study was given freedom to analyze and point out problems as they appeared to it; in this respect the judgment, analyses and recommendations in the report are those of the Special Study and not the Commission. We strongly endorse the general soundness of these chapters as a basis for discussion with the industry, for rulemaking, and for legislative proposals. Without public notice and comment, we may not speak definitively on those

questions involving substantive changes in our rules or the rules of the self-regulatory agencies. In any case, we believe the responsible course of action calls for discussions with the securities industry before final decisions are made.

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

A

In section 19(d) of the Securities Exchange Act, the authorizing resolution for the Special Study, the Congress emphasized an examination of the adequacy of the rules of the self-regulatory agencies. The whole report is a comment on this theme. Chapter II evaluates the rules of the NASD and of the principal exchanges relating to qualifications and chapter III those governing selling practices and investment advice. Chapter VI and VII examine the rules and procedures of the self-regulatory agencies with respect to trading practices in the exchanges and over-the-counter market. Chapter XII, transmitted today, analyses the organization and self-regulatory operation of those agencies, with primary emphasis on the New York Stock Exchange and the National Association of Securities Dealers, Inc., and their relationship to the Commission and each other.

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

1

The New York Stock Exchange occupies an unrivalled position as a self-regulatory institution because of its importance as a market and because of the dominant position of its membership in the securities business. We believe it important to point out, first, that the study quite properly devoted particular attention to problem areas and, secondly, that, although there are defects in the functioning of the Exchange market which should be corrected, the Exchange has worked diligently, and on the whole successfully, to maintain a fair and honest market. The report points out the strong performance of the Exchange in many areas, including qualifications and net capital. Its disclosure and related requirements, some antedating the enactment of the Federal securities laws, represent a major contribution to in-

vestor protection and, in some respects, have gone beyond anything the Commission could do. In certain areas, judged by the Exchange's own standards of accomplishment, performance has been less satisfactory. For example, controls over branch office operations and investment advisory and selling practices require strengthening; the Exchange itself has recognized this in its initiation of new programs. The report discloses a failure of regulation over odd-lot dealers, and raises serious questions about floor trading. The Special Study's examination of the Exchange's specialist system reveals no widespread abuses or patterns of illegality. On the other hand, there are subtle and complex problems discussed in the report which call for examination and review by the Exchange and the Commission with a view to strengthening the system and raising the quality of operation of some segments to that of the most effective and most efficient.

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

The importance of the New York Stock Exchange as a self-regulatory institution and as a market makes it imperative that it bring its entire level of performance up to its demonstrated capabilities. The recommendations in chapter XII–B of the report and elsewhere are designed, as the report states, "to point toward an even stronger future role" for the Exchange. With limited reservations in two instances which are footnoted below, we agree with these recommendations.[1]

2

Early in 1962 the Division of Trading and Exchanges of the Commission, in conjunction with the Special Study of Securities Markets, issued a report concerning the American Stock Exchange. This report pointed out serious problems in regard to the operations of that exchange and practices occurring on its floor. The American Stock Exchange, together with selected representatives from the securities

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

industry, and in consultation with the Commission, has since engaged in a substantial reorganization of its management, constitution and operations. As the report concluded in subchapter XII–C: "In contrast to the prior breakdown of self-regulation described in the staff report, the accomplishment of this reform appears to be an excellent demonstration of the effectiveness of self-regulation under responsible exchange leadership and active Commission oversight." It is apparent that the American Stock Exchange has now instituted a responsible regulatory system as a basis for meeting its obligations under the Exchange Act, including problems it shares with the NYSE.

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

3

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

The work of the NASD is in large measure performed by its members who volunteer their time and effort to the job of self-regulation. The NASD has established important standards of business conduct, including restrictions against unconscionable underwriting compensation and rules dealing with "free-riding." It has assisted in the general enforcement efforts against overreaching and abuses in the over-the-counter market. However, there are many key areas in need of improvement in the over-the-counter market, in terms of new standards, as well as strengthened enforcement programs. In this context, certain organizational characteristics, including the emphasis on member participation and the heavy demands on the Board of Governors, necessitate significant rethinking and redirection. More effective regulation requires a larger staff—a direction in which the NASD has been moving during the last few years—with increased responsibility and a reallocation of work among member participants in the government of the NASD. The participants would then have more opportunity to consider general policy and the NASD could better carry its formidable workload.

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

4

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

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

We shall examine with the exchanges the need for further procedural safeguards for those affected by exchange actions—a problem that has taken on new significance because of the recent Supreme

Court case of *Silver* v. *New York Stock Exchange*. In addition, as suggested by both subchapters XII–I and XII–J, we will confer with the self-regulatory agencies to determine methods by which enforcement and inspection responsibilities can be better allocated between the Commission and the self-regulatory agencies and among those agencies themselves.

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

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

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

B

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

The staff of the Special Study received generous assistance and cooperation from the staff of the Board of Governors who reviewed chapter X from a technical point of view and who also prepared all of the appendixes. Of course, none of the Reserve personnel, nor the

Board, is in any way responsible for the final views expressed in the chapter.

C

Chapter XI of the study deals with selected aspects of open-end investment companies, so-called "mutual funds," including selling practices, contractual plans, insider trading in portfolio securities and portfolio-brokerage reciprocal business patterns. It must be emphasized that this chapter should in no way be construed as a reflection upon the investment merits of mutual fund shares, upon the investment company as an important vehicle for investment, or upon any particular company. Furthermore, it should also be emphasized that the questions raised with respect to contractual plans do not, and should not, affect present holders of these plans. As the study has stated, its analysis should not be taken by any planholder as a reason for redeeming any plan certificates. Early redemption of a plan almost invariably results in loss to the planholder. The problems analyzed by the report are in no way related to the merits of the underlying investments or to shares bought outright. The recommendations are focused solely on *future* contractual plans as distinguished from plans already entered into.

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

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

As the Congress is aware, on August 27, 1962, the Commission transmitted to the Congress "A Study of Mutual Funds," representing a factfinding survey of certain aspects and practices of open-end investment companies. This study was prepared by the Wharton School

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

of Finance and Commerce of the University of Pennsylvania. At the same time, the Commission requested its Division of Corporate Regulation to undertake a detailed analysis of the Wharton School Study and conduct its own examination into structural problems of mutual funds. That examination should be submitted to the Commission sometime late this year or early in 1964. Meanwhile, chapter XI of the report represents an important contribution to the overall picture.

D

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

As pointed out in subchapter XIII–E, neither the report of the study nor that of the New York Stock Exchange was able to isolate and identify the causes of the market events of May 28, 29, and 31. Moreover, contrary to some speculation at the time that the events might be the result of some conspiracy, neither of these reports presents any evidence that the break was deliberately precipitated by any group or resulted from manipulation or illegal conduct in the functioning of the market.

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

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

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

The various recommendations made elsewhere in the report, in part

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

III

This transmittal completes the Report of the Special Study of Securities Markets. The report is clearly the most thorough examination of the securities markets since the early 1930's. Size alone is but a poor measure of its importance and achievement. The report would have high usefulness if only for its orderly presentation of basic facts about the markets. More importantly it offers a foundation for regulatory and industry actions for a long period to come.

Implementation of the report can be prompt in many cases. Fundamental recommendations of the Special Study have already been incorporated in the Commission's legislative proposals, embodied in S. 1642, as amended, H.R. 6789, and H.R. 6793. S. 1642, as amended, has passed the Senate and, together with H.R. 6789 and 6793, is now pending before the House of Representatives. It is our judgment that these bills represent essential amendments to the securities laws. By providing for more reliable and extensive disclosure as to companies traded in the over-the-counter market and by raising qualifi-

cation standards for those dealing in over-the-counter securities, enactment of the bills will have a pervasive impact on the raising of standards in the securities markets and will serve as a base to achieve many of the improvements suggested by the study. At the same time, as we noted in connection with the transmission of chapters V through VIII, the legislative program stands by itself; thus consideration of the bills can appropriately proceed independently of the discussion and resolution of the questions raised in the chapters here transmitted.

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

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

IV

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

to produce a comprehensive, overall view of securities regulation. But what we have done is not so important as what we must do—and that must be the case with the self-regulatory agencies and the financial community as well.

* * * * * * *

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

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

By direction of the Commission.

WILLIAM L. CARY,
Chairman.

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