

NASD

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To NASD Members and Registered Representatives:

NEW GOVERNORS, OFFICERS ELECTED BY NASD BOARD

Gordon Teach was nominated at the September Board meeting to be the 1970 Chairman of the Board of Governors. A first vice president of Shearson, Hammill & Co., Inc., he has served the Association as Chairman of the National Business Conduct Committee and Chairman of one of the Association's District Committees. He has also held influential positions with the Investment Bankers Association, the Midwest Stock Exchange, and the Chicago Association of Stock Exchange Firms. He has been a member of the Board of Governors since 1968. In January, Teach will assume the position vacated by Kenneth Sayre, a partner in Irving, Lundborg & Co.

Francis S. McComb, Executive Vice President of Wagenseller & Durst, Inc., Los Angeles; and **J. Howard Carlson**, a partner of Loeb, Rhoads & Co., New York City, (both members of the Board since 1968) were nominated as Vice Chairmen of the Board for 1970. They will succeed W. Scott Cluett of Harriman, Ripley & Co., New York City; and R. S. Abernethy of Interstate Securities Corporation, Charlotte, North Carolina.

John M. Bleakie, a partner of W. E. Hutton and Co., Boston, will be Chairman of the Association's Finance Committee, succeeding C. Rader McCulley of the First Southwest Company, Dallas.

Last summer the membership approved expanding the Board of Governors from 23 to 24 members, with the new position to be a Governor-at-Large to represent insurance company members.

In September, the Board nominated **Peter Wilde**, president of CG Equity Sales, a subsidiary of Connecticut General Life Insurance Co., to fill the new position. Wilde, who has been active in the NASD as a member of the Investment Companies Committee, will begin his three-year term in January of 1970.

He has been with Connecticut General Life since 1955. In 1963, he was appointed Assistant Secretary of that organization and in 1966 became the Director of Product Marketing. In 1967, he was named Director of Equity Fund Development, and in 1969, Director of Mutual Funds. His present responsibilities were assumed this fall.

In addition, seven new Governors from the securities industry were elected to the Board for terms beginning in January, 1970. They are:

District No. 2—**A. B. Fox**, President of Stern, Frank Meyer & Fox, Inc., Los Angeles, California; District No. 4—**Peter C. Barnes**, a Partner in H. O. Peet & Co., Kansas City, Mo.; District No. 6—**Jonathan C. Calvert**, Vice-President of

**NATIONWIDE OTC CLEARING
SYSTEM, TO BE A
SUBSIDIARY OF THE NASD,
ACQUIRES MORGAN AS
PRESIDENT**

Rotan, Mosle-Dallas Union, Inc., San Antonio, Texas; District No. 8—**J. Robert Doyle**, President, Doyle, O'Connor & Co., Chicago, Ill.; and **R. Ron Heiligenstein**, President and Treasurer, Mid-America Bond & Share Co., Inc., Decatur, Ill.; District No. 10—**Kenneth M. Crosby**, a Vice-President with Merrill Lynch, Pierce, Fenner & Smith, Inc., Washington, D.C.; and District No. 12—**Robert S. Driscoll**, Partner, Lord, Abnett & Co., New York, New York.

David H. Morgan, former president of the Pacific Coast Stock Exchange Clearing Corporation, recently joined the NASD as president-designate of the NASD's National Clearing Corporation. Morgan had been with the Pacific Coast organization since 1967. He is a graduate of Northwestern University and has held responsible positions with the U.S. Steel Corporation and the accounting firm of Peat Marwick Mitchell & Company.

The Corporation that Morgan will head is being designed to clear securities transactions between NASD members, thus easing the "fails" problem that has plagued industry members and their customers.

Although the national clearing corporation is not expected to begin operation until 1970, Morgan and the Clearing Committee, NASD staff members, and industry advisors have been tackling a host of organizational, financial, and legal details necessary for formation of the new system.

The Committee has drafted by-laws which reflect the clearing system as a non-profit subsidiary of the NASD—the form that the organization is expected to take. The Corporation will establish area centers as part of its first phase of operation. Initially, these centers will be responsible for processing intra-area trades and will be located, for example, in New York, the Midwest and the Pacific Coast. Regional centers, where needed within the area, would be established in a later phase. The plan also calls for a national center which would participate in the processing of inter-area trades, also to be established at a later date. Tie-ins to existing facilities will be planned wherever possible, for reasons of efficiency, early implementation, and economy. Meetings have been held with the various exchanges, clearing corporations, and industry members concerning these plans.

Liaison meetings with the Securities and Exchange Commission have also been held to determine how the new system will be regulated. In addition, the problem of the type and amount of insurance needed for both the corporation and its members is being studied.

One of the main difficulties in setting up such a system is the dearth of concrete statistics on the volume, type of trading, and back office operations in the OTC market. A study done by the Arthur D. Little Company estimates that approximately 5 billion shares are traded on the OTC market each year. The SEC estimates that 26,000 different stocks are traded on the OTC market in a year.

However, these are only estimates. In order to more accurately determine the information on the OTC market, the Association is sponsoring a study by NERA Systems, an affiliate of National Economic Research Associates. The basis for the study will be the sampling of confirmation/comparison slips taken over a five day period. This report will be completed in December.

Combined with the above study is a questionnaire sent to all member firms. The questionnaire asks specific questions about the volume of OTC transactions; cost of clearing these transactions; membership in exchanges and organized clearing facilities; and back office conditions. The questionnaire has been mailed to mem-

bers and response is expected shortly. An important benefit of these studies is to help determine the economics of the proposed OTC clearing system.

In connection with the planning of the system, a pilot project to facilitate clearing OTC securities between New York City and West Coast brokers was begun on an experimental basis in September. The National OTC Clearing Corporation (New York) and Pacific Coast Stock Exchange Clearing Corporation were involved in the successful project, which, according to John Kirvin, Chairman of the NOTC, and Thomas Phelan, President of the PCSE, will be expanded.

The project involved the New York Hanseatic Corporation, an NOTC member, which cleared all its trades with the First California Company through the POTC, a subsidiary clearing company specifically established to clear over-the-counter securities transactions of the Pacific Coast Stock Exchange Clearing Corporation members. The PCSE designed the net-by-net system, which has been adapted to meet the needs of a nationwide system.

Since the initial clearing operation between New York Hanseatic and the First California Company, other firms on the West Coast and in New York have been added to the program. The NASD recognizes that this project is a significant step in setting up a viable NASD clearing system.

NASD REQUIRES CONTINUED COMPLIANCE WITH INTEREST EQUALIZATION TAX ACT

September 30 marked the second time this year that Congress allowed the Interest Equalization Tax Act to lapse. On that day, action on the bill (which had been passed by the House) was blocked in the Senate by Senator Edward Kennedy (D.-Mass.), Acting Majority Leader, because of an unrelated amendment regarding the Gun Control Act of 1968 that had been added.

Because of this situation, the NASD, at the request of the U.S. Treasury Department, followed the same procedure that had been used earlier this year. Members were instructed to comply with the tax, with non-compliance considered a violation of NASD regulations—a step that was taken in the interest of preserving order in the market.

The bill was passed by the Senate on October 9, 1969, with its provisions retroactive to October 1, 1969. The bill has not yet been signed into law by President Nixon.

In connection with this legislation there have been many changes in the Internal Revenue Service's list of "Participating Firms and Custodians"—those broker/dealers and banks dealing in foreign securities subject to the Interest Equalization Tax.

Because of these changes, members are requested to review and update their records, particularly noting those firms and custodians that have been deleted from the IRS list. The latest copy of the list may be obtained from the U.S. Treasury Department, Internal Revenue Service, Washington, D.C.

NOVEMBER CONFERENCE TO EXAMINE STOLEN SECURITIES PROBLEM

A number of industry organizations are sponsoring the Security Control Conference to be held in New York City on November 24, 25, and 26. Over 40 professionals will speak during the program, including the Association's David Morgan, President of the National Clearing Corporation. The program, geared for management personnel, emphasizes the increasing problem of stolen or misplaced certificates and outlines measures to protect firms and customers from loss. For additional information contact: The Security Control Conference, 300 Madison Avenue, 9th Floor, New York, New York 10017.

**BOARD OF GOVERNORS
DENOUNCES "SWITCHING,"
URGES NEW RECORDS**

In September, the NASD Board of Governors asked that the following statement on switching be communicated to members and their representatives through the NASD NEWS:

Inquiries from members indicate that some further statement on this subject is desirable. That it may also be necessary is indicated by the increased rate in recent years of mutual fund redemptions as a proportion of total fund assets. Furthermore, by reason of the fact that mutual fund companies themselves repurchase or redeem shares being liquidated, frequent trading may have an impact on the remaining shareholders of the fund involved that gives this matter an importance not limited to the effect on the particular account for whom the switch is made.

In previous comments, it has been pointed out that letters from customers acknowledging their awareness of various factors involved in a switch were secured by some members although this has never been required; indeed, while such letters may serve a useful purpose in the internal operation of a member, these have not been considered as conclusive evidence of the propriety of the transactions concerned.

Section 1 of Article III of the Rules of Fair Practice requires that "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." Section 2 requires that "In recommending to a customer the purchase, sales or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

In connection with the latter Section, a Policy Statement of the Board of Governors related to "Fair Dealing With Customers" includes the comment that "sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers".

While, therefore, letters from customers expressing their understanding of such trades may have some value, the above considerations must be the basic "ground rules" for determining the propriety of any recommendation—"switch" or otherwise—with respect to shares of a mutual fund as with any other security.

In judging whether a member's transactions involving trading or switching of mutual funds properly conform to these basic requirements, considerable weight would be given to the appearance of any pattern, such as the frequency with which changes in holdings were made, or the extent to which they were general.

In this connection, it appears clear that an increasing proportion and amount of mutual fund shares that are being liquidated are being redeemed by direct tender of the shares to the fund, or its agent, by the shareholder, often at the suggestion of the member or its representatives. To the extent this is done, there often is no record of such transactions on the books of the member, which also may mean that the member is without knowledge of this type of transaction relative to sales made by its representatives.

Accordingly, it is the position of the Board of Governors that members are under an obligation to supervise transactions in a manner which will ensure that improper "switching" is not taking place within their organization. Members may be called upon to demonstrate the extent and nature of such supervision. One method which a member might adopt is to maintain records which will indicate whether, to their knowledge, purchases of mutual fund shares by their customers are made

with the proceeds of the liquidation of shares of other funds. This could be done by having the following statements appear on sales tickets or supplemental records:

1. To your knowledge, does this purchase represent a trade from another mutual fund? Yes ()
No ()

2. If "yes", was the other fund liquidated through our firm? ()
Or by a direct redemption? ()

**NASD ASKS SUPREME COURT
REVIEW OF FIRST NATIONAL
CITY BANK CASE**

During the September meeting of the Board of Governors, it was decided that the NASD would seek Supreme Court review of a July decision handed down by the United States Court of Appeals for the District of Columbia. The decision allows banks to operate co-mingled investment accounts.

Three cases were resolved by the decision, all stemming from a fund operated by the First National City Bank of New York. In these cases, the Investment Company Institute and the NASD challenged the legality of banks being able to operate co-mingled investment accounts under the Glass-Steagall Act and the Investment Company Act. The ICI has also announced that it will ask for Supreme Court review of the decision.

The Mutual Fund Bill (also known as the Sparkman Bill) that has been passed by the Senate and is currently being examined through hearings before a subcommittee of the House Commerce Committee would supersede the Court of Appeals decision. However, the outcome of the Bill is not predictable at this time, particularly in this session of Congress.

**INSTITUTIONAL INVESTORS
STUDY RECEIVES TIME
EXTENSION FROM CONGRESS**

The Institutional Investors Study, being conducted under the umbrella of the Securities and Exchange Commission, sent out its first questionnaires to institutional investors this fall. A series of questionnaires have gone to banks, insurance companies, and investment advisers requesting information on their purchases, sales, and holdings of securities. By the end of the year, additional questionnaires will be sent to a small sample of broker/dealers and other institutional investors.

Present SEC plans call for analysis of data during early 1970 and preparation of a full report during the summer of that year. The study should be completed by September of 1970.

The study, which was authorized by Congress last year through an Amendment to the Securities and Exchange Act of 1934, has as its purpose an "investigation of the purchase, sale and holding of securities by institutional investors of all types . . . in order to determine the effect . . . upon (A) the maintenance of fair and orderly securities markets, (B) the stability of such markets . . . (C) the interests of the issuers of such securities, and (D) the interests of the public, in order that . . . Congress may determine what measures, if any, may be necessary and appropriate in the public interest."

Under the original legislation, the study was to have been wrapped up by September of 1969, but a delay in appropriating funds and hiring personnel made this goal unattainable. Accordingly, last month, Congress extended the time period until September, 1970, and continued a total appropriation of \$875,000 for the study.

Headed by Dr. Donald Farrar, the 33 member study staff consists mainly of outstanding economists recruited from American universities and industry, with several attorneys and a few SEC staff members also participating.

Cooperating with the study staff are various industry organizations, including the NASD. The NASD is acting mainly in an advisory capacity. An Inter-Industry Committee consisting of 12 members and 12 alternates has been actively working with the staff. John C. Whitehead, a partner in Goldman, Sachs and Company in New York, is the Chairman of the Committee. He is also Chairman of the Investment Bankers Association's Research Committee.

According to the study plans, the background section will contain historical data centered primarily on asset holdings and savings flow by financial institutions.

The section on institutional studies will directly cover the institutional investors through examination of management types of investment organizations (such as insurance companies, bank trust departments, etc.) rather than portfolio types (for example, mutual and pension funds). The growth, efficiency and behavior of these institutions and related issues will be probed.

In the market studies section, institutional trading and its relationship to market liquidity and market organization will be scrutinized as well as factors influencing institutional investors in their choice of markets to handle their transactions.

The relationship between institutional investors and the managements of companies whose securities are held by these investors will be the focal point of the portfolio companies section. This part of the study also aims to determine institutional preferences between different types of securities; institutional participation in new financing; and the position of institutional investors in transfers of corporate control.

The continuous reporting section will consider how to improve and/or obtain necessary data on institutional investing needed by government and regulatory agencies, private investors, and the general public.

NASD EXAMINATION PROCEDURES STRESSED

Member attention is directed to the following procedures for the NASD Qualification Examinations:

Special Sessions: Special sessions can only be arranged by member firms. No requests will be accepted by any other organizations, including training schools. All written requests must be sent to the Executive Office of the Association in care of Qualification Examination Department which authorizes and handles arrangements for all special sessions. Costs involved in the administration of the examinations will be borne by the firm or firms requesting the session.

Each candidate will be required to present a valid certificate or letter before being permitted to take an examination. Only candidates affiliated with the member firm requesting the session will be allowed to attend.

Regular Sessions: Candidates for the examinations should be at the Examination Center one half-hour before the session is scheduled to begin. Again, each candidate is required to present a valid certificate, letter or telegram from the Association before he will be admitted to the Examination Center.

Members are reminded that, since changes in the examination schedule are frequent, it is advisable to confirm times and dates with the appropriate District Secretary.

**COMMITTEE ON UNDER-
WRITING ARRANGEMENTS
ASSUMES NEW NAME AND
BROADER DUTIES**

The Committee on Underwriting Arrangements left the September NASD Board meeting with a new name, expanded duties, and two newly created study groups which will be associated with the Committee.

The Committee is now officially known as the COMMITTEE ON CORPORATE FINANCING—a name which encompasses its broad responsibilities. The Committee will continue its former duties, but will also expand its scope. Part of this expansion includes the review of two new areas: issues handled directly by a company, but open to NASD member participation; and issues offered directly by a company but which are facilitated in one way or another by some member firms. These areas have been added as a result of concern about some industry abuses that have been occurring.

The formation of the two study groups was approved by the Board. One will study the distribution and arrangements of real estate and mortgage investment trusts and the other will examine oil and gas programs. The objective of these groups is to determine the problems, if any, in these areas and to report their recommendations to the Committee on the need for special guidelines.

The Committee Chairman reported that the work load handled by the group has substantially increased and compared the 1968 figure of 2100 new issues filed with the Association to the 3100 already filed with the NASD in the first 8 months of 1969. The volume is expected to increase significantly as the Committee's duties expand.

Presently, the Committee is polishing new guidelines for use by NASD members which are designed to disclose more specifically what the Committee will be examining, its areas of concern and stated requirements.

Although the guidelines contain more direction for members than the guidelines drawn up last year, they represent little change from the Committee's practices under the current guidelines.

When the guidelines are in final form, they will be distributed directly to members. Members are asked to read these guidelines carefully, and, if they have questions, to direct them to the Corporate Financing Department of the NASD in Washington.

**NASDAQ SYSTEM/
A PROGRESS REPORT**

October reports show industry acceptance and enthusiasm for NASD's new over-the-counter quotations system surpassing the Association's projections. NASDAQ, which is being designed by the Bunker Ramo Corporation, had 212 firms under contract for Level II service and 454 for Level III service as of October 17.

The Bunker-Ramo building in Trumbull, Connecticut, that will house the central NASDAQ computers, has been completed; the computers have been installed, and programming is in progress. Production of the NASDAQ terminals will begin in April of 1970 with installations in subscriber firms beginning the following month.

Latest Association estimates place the number of OTC securities to be covered by NASDAQ when it begins operation at 3,000—perhaps double the figure originally estimated.

Richard Walbert, NASD president, during a speech before the Security Traders Association's October meeting, emphasized that "NASDAQ has the potential of changing the entire image of the OTC market in the minds of investors throughout the world. It is capable of attracting to the market thousands of investors who so far have veered away . . . because they do not understand it."

MANAGEMENT & SUPERVISION

NOTES

**EMERGENCY RULE CHANGE/
NASD BOARD INTERPRETA-
TION MUST BE NOTED
BY MEMBERS**

**CLOSE TABS ARE KEPT
ON "FAILS" SITUATION**

The Association has recently become aware that some member firms may not be fully complying with Emergency Rule 69-15 because they are not aware that the rule was modified and re-enacted at the September Board meeting. A notice concerning this rule and two other emergency rules re-enacted at the same time was sent to members on September 24, 1969. There were no changes in the other two rules.

The change in Emergency Rule 69-15 (relating to trading restrictions) requires that no member or person associated with a member buy or sell a security for his own or a customer's account if (among other requirements listed by the rule) he has a fail to deliver in the security **90 days or older**.

Formerly, this figure was 120 days. Paralleling this change, **members with any fails to receive or deliver 90 days or older must file a list of such securities with the appropriate NASD District within 10 days after the end of each month**. Reporting details are found in the actual text of the rule.

In addition, the Association would like to re-iterate a September 4, 1968 Interpretation of the Board of Governors which prohibits a member from executing customer sell orders unless the securities involved will be promptly delivered.

Members should be aware that, in order to comply with this interpretation, a member may not accept a new issue sell order unless the member originally sold the securities to the customer, making the customer long in his account with the member. This prohibition is in force unless the customer either possesses the security or can offer reasonable assurance that the security will be delivered in good form within five days.

The Interpretation states, in part, that no member shall execute a sell order for any customer unless one or more of the following conditions are met:

- (1) The member has possession of the security.
- (2) The customer is long in his account with a member.
- (3) Reasonable assurance has been received by the member from the customer that the securities will be delivered in good form within five business days of the execution.
- (4) The security is on deposit in good form with another broker/dealer, state or federal bank, and instructions have been given to the depositor to deliver the securities against payment.

Because of the significant upturn in volume during the past several weeks on the nation's stock exchanges and in the over-the-counter market, the NASD has taken action to step up its regulatory surveillance of members. These new measures are designed to insure that adequate restraints are being taken by the industry to avoid critical back office paper work and delivery problems which plagued broker/dealers during much of 1968.

A detailed questionnaire was recently sent to a select number of members in order to obtain current data about the number of fails to deliver securities and the age of these fails carried on members' books. During the past year, the number of fails to deliver or receive has been a major industry barometer measuring the capability of handling additional paperwork and volume.

"This latest Association questionnaire will include the 200 NASD members that do the majority of the over-the-counter business and is just part of our continuing program to control the fails situation," Richard Walbert, president of the Association, stressed.

In addition to the latest survey, the Association has approximately 100 firms which report their fails on a monthly basis and a large number who are on a frequent reporting basis.

The Association also has a special inspection program, launched in the spring of 1968, aimed at keeping a close watch on the operational capacity and financial condition of its members. The Association also restricts the volume of firms who have high "fails" and there are presently 23 firms on restriction for high "fails."

Disciplinary actions have been taken against a total of 117 members in connection with the fails situation. So far, four members have been expelled, two suspended for varying periods, twenty-two censured and fined and over six hundred have received cautionary letters.

However, the over-all statistics are encouraging. Statistics gathered by the Association through the end of September show that total fails to deliver for a sample group of members had declined 76 percent from figures compiled in January, 1968. In August, 1969, fails to deliver totaled 212.6 million dollars compared with 505.9 million dollars in August of the preceding year.