NASD News

To NASD Members and Registered Representatives:

SELF-UNDERWRITING UNDER CONSIDERATION FOR NASD MEMBERS

The NASD's Self-Underwriting Committee, which was appointed in January, 1970, has been studying ways that member firms could underwrite and distribute their own securities. The Board of Governors, while believing that members should have this opportunity, has prohibited this activity because of inherent conflict of interest problems, such as a firm's obvious lack of objectivity in setting the offering price and the question of whether such securities are suitable for specific accounts.

Presently, the Board is considering rules which would allow qualified members to underwrite and distribute their own securities, while building in protection for the public. Those firms that do not have an established business history and that lack experienced management would still be prevented from engaging in this activity.

The proposed rules were designed by the Self-Underwriting Committee, which is headed by Howard E. Buhse, Chairman of the Board of Directing Partners of Hornblower & Weeks-Hemphill, Noyes. The Committee has been working on the rules since January.

The self-underwriting qualifications suggested by the Committee are: (1) A member must have been in business for at least five years before filing a registration statement for the issue, and three of those years would have to be profitable for the firm; (2) The majority of the Board of Directors must have been in the securities business for five years before the offering; and (3) A member's net capital ratio would have to be 10 to 1 immediately after the offering, rather than the 20 to 1 ratio required by the SEC.

The main problem, which the Committee believes has been resolved, has been the lack of arms-length bargaining in determining the offering price. The Committee has proposed that the price be established by two qualified independent underwriters, represented by independent legal counsel. Under the proposed rules, the underwriters would also have to demonstrate a business history similar to that of the issuer. They would also have to have at least a five year history of underwriting securities. The proposed rules *would* allow the independent underwriters to participate in the distribution of the securities.

Requirements for the offering and distribution of member securities (whether or not they are self-underwritten) have also been proposed. They would be: (1) The issue could be no larger than twice the net worth of the issuer; (2) Financial statements for the last three years must be furnished; (3) A certified balance sheet must be furnished on a date no more than 90 days prior to the filing of the registration statement; (4) No more than 25 percent of the interest of the present owners could be offered in the initial distribution; (5) The balance of the owners' shares could not be sold for one year; and (6) At least one year would have to pass before the member could make another public offering of its securities.

The proposals do not bar members that do not qualify to underwrite their own securities from going public. They have the option of using an independent underwriter—a practice which is presently allowed. However, under this arrangement, the member would not be able to participate in the distribution of the securities.

The Association is also considering requiring all members making a public offering of their own securities to send shareholders quarterly statements disclosing all important facts about the company. In addition, these firms would have to mail independently audited and certified financial statements to their shareholders each year.

In a related matter, the Committee has concluded that "after-market" trading by members in their own securities is not permissible under existing securities laws.

The Board of Governors has approved these concepts and has relayed the proposals to the membership for comment.

NASDAQ: Off To A Running Start

The NASDAQ system began on February 8, 1971, and has been operating with few problems ever since. This new automated quotations system has been welcomed by the industry and investors. It has proved to be a time-saver, by freeing traders from constant telephoning; and has provided instantaneous pricing information for NASDAQ subscribers, often connecting them in transactions with firms they have never done business with before. It has made the over-the-counter market more competitive, and hence a stronger marketplace.

System Growth

Queries received by the NASDAQ central computers in Trumbull, Connecticut, have been growing. When NASDAQ began, the system was handling about 375,000 queries each day—a figure which is now over 600,000 queries per day. Requests for quotations alone are running generally above 500,000 each day; the number of quote updates from market makers number about 50,000; while queries relating to volume input and/or verification make up the remainder.

The number of securities on NASDAQ continues to expand, although some have been dropped because of inability to continue meeting NASDAQ requirements. On April 20, 1971, there were 2,608 securities carried on the NASDAQ system—an increase of about 100 since the birth of the system.

New Registration Procedures

New procedures, designed for ease of registration, should increase the number of securities on NASDAQ. They are:

- Simply by picking up the telephone, NASDAQ market makers can now request registration in any equity security. The telephone request, which must be confirmed in writing, will allow the NASDAQ Department to check the eligibility of a security and to see if it can be authorized for the system. This should prove to be a time-saver.

- The Association soon will begin making known to NASDAQ subscribers through the NASDAQ "NEWS" service those securities which are eligible for NASDAQ, but which lack the required number of market makers. If another firm is interested in making a market in any of these securities, it should notify NASDAQ—New York (212-269-6393).

- A new NASDAQ symbol directory was published near the end of April. The cut-off date for changes in the directory was April 14th, and market makers were urged to keep a record of any changes after that date. All new information relating to the symbol directory will appear on the NASDAQ "NEWS" service.

Volume Reporting

Some problems connected with NASDAQ remain. One is the problem of some market makers reporting inaccurate volume information, or no volume at all. Until the users fulfill their responsibilities in transmitting correct volume figures, the Association will not be able to release volume to the press.

Since the Association is anxious to get this information in the hands of investors, procedures have been developed to check the reporting of volume. However, this is not enough. The NASDAQ Department strongly urges market makers to cooperate in this area, as well as carefully complying with other NASDAQ regulatory requirements.

In addition, the Association will be carrying out a study to verify volume entered into the system. This study will be done by the District Offices' examining staffs, and will entail special examinations of all firms and branches with Level III NASDAQ equipment. Eventually, the Association intends to make NASDAQ volume verification, as well as other NASDAQ surveillance checks, part of the standard examination of books and records carried out by the NASD examining force. In this study, the examiners will be supplied with NASDAQ data which they will compare with the firms' actual records regarding OTC transactions.

Disclosure for NASDAQ Companies

For proper regulation, the NASDAQ Department must have access to important information about the companies whose securities are included on the system. Realizing this, the Securities and Exchange Commission has proposed disclosure rules which would make this information available. The rules are expected to become effective soon. Primarily, they relate to dividends, stock splits and rights information as well as basic information regarding corporate name changes and changes in the number of shares outstanding for each NASDAQ company. Until the SEC rules become effective, the Association has advised all companies whose securities are included in NASDAQ that this information is necessary, and has supplied a form for their use. This form is available from the NASD, 17 Battery Place, New York, New York, 10004, Attention: Issuer Reports.

Third Market Securities

Much debate has occurred in the past concerning whether the Association should or should not include listed securities on NASDAQ. In order to help provide facts about this question the Board of Governors voted in March to include a control group of listed securities on the NASDAQ system. These third market securities have been included on a test basis in NASDAQ since April 5, 1971. The test period will last from 90 to 180 days.

The NASD is examining transactions in listed securities before and after their inclusion in the system to determine the characteristics of OTC trading in listed stocks in contrast to exchange markets. The securities that are being studied were selected by OTC market markers and the Board of Governors.

The NASDAQ system is growing, changing and improving. The Association is committed to refining the system so that it will serve investors and participating firms even more effectively in the future. This may mean including third market securities. It may eventually mean linking NASDAQ to the National Clearing Corporation's planned OTC clearing program. It will probably mean adapting the system to new technological developments which are not predictable now.

Although major decisions remain to be made, one thing is certain. NASDAQ is a positive force in speeding up operations in the over-the-counter market and in providing fast and accurate pricing information for investors and the industry for the first time.

SUPREME COURT BARS BANKS FROM SELLING MUTUAL FUNDS

In a landmark decision ending several years of legal controversy, the U. S. Supreme Court recently ruled that banks cannot create, manage and sell mutual fund type investment accounts. The Court's decision, based primarily on the Glass-Steagall Act of 1933, supports the NASD's belief that the Act prohibits banks from operating mutual funds.

The case which drew the Court ruling involved the First National City Bank of New York, the only bank operating a mutual fund type of investment program. After a ruling by the Comptroller of the Currency that banks could pool managing agency accounts, Citibank developed its plan, under which a customer, with a required minimum initial participation of $10,000, authorized the bank to be managing agent of his money. Customers' funds were pooled for investment while each customer received a document as evidence of his share of participation in the fund.

The registration of the fund under the Investment Company Act of 1940 was required by the Securities and Exchange Commission which then granted Citibank an exemption from a provision of that Act prohibiting a bank from having a majority of the directorships of an investment company.

At this point the Investment Company Institute, representing the mutual funds, filed suit in Federal District Court, alleging that the Comptroller's action was in violation of the Glass-Steagall Act. The local court agreed, but the Comptroller and Citibank appealed to the U. S. Circuit Court of Appeals for the District of Columbia. Simultaneously the NASD appealed to the same court for a reversal of the SEC exemption from the Investment Company Act granted to Citibank. The circuit court decided both cases in favor of Citibank; whereupon the NASD and the ICI turned to the Supreme Court.

Discussion of the issue had not been solely confined to the judiciary. When Congress had before it the recently enacted mutual fund legislation, it considered including a provision to allow banks to manage mutual fund type accounts. The NASD opposed this provision in testimony at Congressional hearings. A House-Senate Conference Committee deleted the measure from the final legislation, leaving the question to be resolved by the Supreme Court.

The Court's majority opinion, written by Justice Potter Stewart, explains the high court's reversal of the Circuit Court decision, ". . . promotional and other pressures incidental to the operation of an investment fund . . . involve the same kinds of potential abuses that Congress intended to guard against when it legislated against bank security affiliates. . . . In sum Congress acted to keep commercial

banks out of the investment banking business largely because it believed that the promotional incentives of investment banking (were) destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system."

LEVEL II NASDAQ SERVICE SOON WILL BE OFFERED TO NON-ASSOCIATION MEMBERS

The NASD Board of Governors took action at its May 4th meeting in Hot Springs, Virginia, so that non-members may soon subscribe to the Level II service now provided to members through the Association's new automated quotation system (NASDAQ) for the over-the-counter securities market.

It is expected that as a result of the decision, many of the nation's largest private investing groups such as the banks and insurance companies will soon have access to Level II service.

The NASD tentatively proposed a monthly assessment of $75 for each Level II terminal used by non-members in addition to the present basic monthly charge for each terminal. The basic monthly charge fluctuates between $450 and $200 depending on the number of terminals per location and the frequency of their use. The proposed additional $75 assessment will offset a portion of the $1.3 million in development costs borne over the past 4½ years by the NASD membership and more than $860,000 in projected annual expenses which the members of the NASD will provide for NASDAQ operation each year.

The non-member assessment proposed by the NASD will be reviewed annually by the Association to determine if any further adjustments may be necessary.

NASD STUDIES GUIDELINES FOR TAX-SHELTER PROGRAMS

During the past year, there has been a tremendous increase of interest from both the membership and the public in tax-shelter programs, such as oil and gas programs and real estate syndications. Because of the popularity of these programs, the Association realizes its responsibility to formulate rules relating to investor suitability and other phases of the distribution process. Therefore, work is being done to formulate guidelines which would be suitable for these securities.

Proposed guidelines, entitled "Amendments to the Interpretation of the Board of Governors with Respect to the Review of Corporate Financing," were circulated to the membership in mid-December, 1970, for comment. It now appears that, as a result of developments within the Association and the nature of the comments received, the guidelines will not be adopted until changes have been made. In particular, the sections of the guidelines dealing with real estate, oil and gas and similar programs will not be adopted without further study.

To study these areas, the Association previously formed two committees, one in the area of oil and gas and the other in self-underwriting. These committees have been examining the problems of members going public and self-underwriting of tax-shelter programs.

In addition, the Association appointed a Real Estate Committee in early April to help decide which NASD rules properly apply to real estate syndications and if any additional rules should be devised for this type of security. This committee will not confine itself to real estate, but will also examine requirements for similar programs, such as cattle programs, orange grove programs, and many others.

This new committee is chaired by Jonathan C. Calvert of Rotan, Mosle-Dallas Union, Inc., in San Antonio, Texas. Calvert is an NASD Governor and is also the Chairman of the Oil and Gas Committee which was formed last fall to suggest rules

for the underwriting and distribution of oil and gas programs. He was appointed Chairman of the Real Estate Committee because of his experience with programs which have certain characteristics in common with real estate syndications.

Other members of the new Real Estate Committee are: Richard R. Felker, Financial Service Corporation of America, Atlanta, Ga.; Douglas B. Fletcher, Shareholders Management Company, Los Angeles, California; James H. Levi, Smith, Barney & Co., Incorporated, New York City; Michael R. Linburn, Shearson, Hammill & Co., Inc., New York City; Lee C. McClurkin, Jr., The Robinson-Humphrey Company, Inc., Atlanta, Ga.; Donald A. Simon, Westamerica Securities, Inc., Denver, Colorado; and Thomas M. O'Donnell, McDonald & Company, Cleveland, Ohio.

STIMSON LEE JOINS NATIONAL CLEARING AS VICE PRESIDENT

Stimson S. T. Lee, former Secretary and Vice President of Clearance and Settlement for the New York Stock Exchange Clearing Corporation has joined the National Clearing Corporation as Vice President in charge of New York based operations. In this capacity he is serving as manager of a New York area clearing center which is being set up by the NCC. Until the new clearing center is functioning, Lee will also direct all present clearance activities of the National OTC Clearing Corporation in New York City, which has approximately 240 member firms clearing OTC transactions. The NOTC is a recently acquired subsidiary of the NCC.

Lee brings to the National Clearing Corporation a proven ability in the management of stock clearing operations. His knowledge and expertise will substantially aid in adapting the NOTC's clearing program to fit the NCC's planned nationwide clearing system for broker/dealers in the over-the-counter securities market.

As an officer of the NYSE Stock Clearing Corporation, he was responsible for clearing all reported transactions between approximately 300 member firms in the securities business. These transactions comprised a daily volume of roughly 100,000 securities delivery items, and related money settlements of over $1 billion.

Before joining the staff of the NYSE Stock Clearing Corporation, Lee was manager of the Management Sciences Department of the Service Bureau Corporation, a subsidiary of IBM. During this period he consulted with customers in the processing of such problem areas as financial analysis, market research and economic forecasting.

Lee received his Bachelor of Science degree in Mechanical Engineering at the University of Rochester. At Columbia University, where he majored in Finance, he received a Masters degree in Business Administration. He is active in security industry organizations, and has been a member of the Executive Committee of the Purchase and Sales Division of the Association of Stock Exchange Firms. He has been a member of the Cashiers Division, ASEF; the Association of Systems Management; and the Delivery Problems Committee of the Joint Industry Control Group.

In commenting on the appointment, NCC President David Morgan said, "We are indeed fortunate to obtain the services of a man of Stimson Lee's experience and accomplishment. His intimate knowledge of the stock clearance mechanism in New York City will be of immeasurable assistance in establishing our planned new "net-by-net" system for this area."

NASD MEMBERS MAY NOT JOIN WITH NON-MEMBERS IN SECURITIES DISTRIBUTIONS

We wish to remind members that Section 25, Article III of the Rules of Fair Practice prohibits NASD members and their associated persons from joining with non-members in the distribution of securities.

Two recent events have given rise to unfounded rumors that the prohibition against members' dealing with non-members has been relaxed.

The first is a proceeding pending before the Securities and Exchange Commission concerning abrogation of Section 25 (b) (2), Article III, of the Rules of Fair Practice. These proceedings are still in progress and have not altered prior restrictions in any respect.

The second is the enactment of the Investment Companies Amendments Act of 1970. A section of this law adds certain securities to those exempted securities listed in Section 3 (a) (12) of the Securities Exchange Act of 1934. The new additions are those interests in a separate account of insurance companies that are used in connection with (1) corporate stock bonus pension and profit sharing plans qualified under Section 401 of the Internal Revenue Service Code of 1954; and (2) annuity plans which meet the requirements for the deduction of employer's contributions under Section 404 (a) (2) of the Code. The Association's Rules of Fair Practice do not now apply to these securities (see Section 4, Article I, Rules of Fair Practice) and members may join with non-members in their distribution. In all other respects the provisions of Section 25 still apply.

OTC MARKET STUDY HAS BEEN PUBLISHED

NASD members have been mailed a study, "The Over-The-Counter Market 1969," which has been prepared by the NASD Economics Department. The study examines public agency orders executed in the over-the-counter market by New York Stock Exchange member firms in 1969.

Using statistics which were obtained from the New York Stock Exchange, the study points out some of the changes which are occurring in the over-the-counter market and relates activity in the OTC market to other major securities markets.

Examined in the study is OTC public agency activity which stems from various types of institutional investors. In addition, statistics relating to individual investor activity are explored. The study considers the proportion of the OTC market accounted for by various investor groups; average order sizes and prices per share for each group; the extent of each group's odd-lot trading; and the average agency commission rates paid by the different groups.

In addition, this material specifies the contribution of different geographical areas in the United States to dollar market value, again as applied only to public OTC agency orders by NYSE member firms.

The behavior of individual investors (the relationships between investment behavior and age, income and motivation) in purchasing securities is also scrutinized in the study, as well as size and other characteristics of public OTC orders executed by NYSE member firms on an agency basis.

Since so little information has been published regarding OTC transactions, the Association hopes that this study will provide some illumination in this area.

We've Moved!

The National Association of Securities Dealers has moved into its new headquarters building. Please address all future correspondence to:

1735 K. Street, N.W.
Washington, D.C. 20006

Our old address was: 888 17th Street, N.W., Washington, D.C. 20006.

MANAGEMENT & SUPERVISION NOTES

SMITH-BARNEY CASE CHANGES COMPLEXION

The responsibility of a dealer to disclose market making activity may have been narrowed by a recent appellate court review in connection with Chasin vs. Smith, Barney & Co., Inc. The case centered on the question of whether a dealer was obligated to disclose his status as a market maker to a customer at the time of a sale.

A customer had purchased securities recommended by the broker/dealer for $34,950. After selling the securities about a year later at a substantial loss, the customer sued the firm, claiming that the company had violated the securities laws. His claim was based in part on the theory that the dealer should have disclosed that it was a market maker in the securities purchased.

The orginal decision, dated July 7, 1970, by the United States Court of Appeals for the Second Circuit, held that disclosure of market making to a customer was necessary. According to the decision, "It should be up to the customer whether to buy a particular stock his broker is recommending with full knowledge of whether the broker is maintaining a position in the stock which might color the broker's advice; failure to disclose such a position to a client when recommending a purchase is failure to disclose a material fact within the meaning of Rule 10b-5 of the Securities and Exchange Act of 1934."

However, on March 2, 1970, the appellate court, in a substituted opinion on review, stated that its decision against the dealer was based only on the facts then before the court. In short, the court stated that 10b-5 was violated in the specific situation where the firm did not disclose its market making status when making written recommendations of a customer's portfolio at the customer's request. According to the opinion, this non-disclosure was an omission of material fact. The court awarded the customer damages in the amount of $18,616.64—the loss the customer incurred when he sold the securities purchased from the firm.

The NASD had filed an amicus curiae brief with the United States Court of Appeals for the Second Circuit. The important factor is disclosure of the broker/dealer's possible adverse interest, and this is accomplished when a firm, as required by law, reveals that it is acting in a principal capacity. This fact was disclosed by Smith Barney in this case. The NASD also argued that disclosure of market making activity by a firm could actually encourage a customer to purchase securities, rather than causing him to make further inquiry.

The problem of broker/dealers' obligation to disclose market making activity to a customer is under consideration by the Securities and Exchange Commission. The Commission expects to design guidelines or rules in this area.

Until the situation is better defined, NASD members should check with their legal advisors regarding the ramifications of this case.

SEC EXPELS FIRM FOR MISREPRESENTING FINANCIAL PLANNING

A scheme to defraud "financial planning" clients was one of the major factors which triggered a recent decision to expel a brokerage firm according to the Securities and Exchange Commission. The SEC strongly denounced the respondents in the case for representing themselves as financial planners. The decision stated that the company and the respondents in the case had "represented themselves to be financial planning experts who would choose the best securities for their clients, but, contrary to such representation, substantially limited their recommendations to securities yielding respondents greatest profits . . ."

The firm, which touted its financial planning expertise, actually had no research staff and its "financial planners" included salesmen with little experience who were designing financial plans for clients without supervision.

The firm's advertising program, which the SEC said was "obviously designed to attract unsophisticated investors," frequently referred to the excellence of the company's financial planning services, including statements regarding the supposedly professional services offered by the research staff in gauging trends in the market.

According to the decision, "The record shows that the gist of the scheme to defraud clients was respondents' holding themselves out as financial planners who would exercise their talents to make the best choices for their clients from all available securities, when in fact their efforts were directed at liquidating clients' portfolios and utilizing the proceeds and their clients' other assets to purchase securities which would yield respondents the greatest profits, in some instances in complete disregard for their clients' stated investment objectives."