NASD 72

CONDENSED VERSION

NATIONAL ASSOCIATION OF SECURITIES DEALERS INC.

1735 K STREET N. W., WASHINGTON, D. C. 20006

Chairman's Report

1972 saw some pervasive changes in the securities industry—changes which were the manifestations of a broadscale reformation. This reformation can be felt in the halls of Congress, within the Securities and Exchange Commission and throughout the nation's financial community. It is a new responsiveness, a new awareness of the responsibilities of the securities industry. It is a rededication to the cornerstone of the securities industry—the investor.

Congressional concern for the investor, particularly in the areas of customer protection and uniform clearing procedures, has been expressed in legislation, hearings by panels in both the House of Representatives and Senate, and committee reports. As a reflector of the public interest, the SEC issued a host of investor-oriented regulations throughout 1972.

The securities industry's version of the consumer movement has manifested itself within the Association with the launching two years ago of NASDAQ, the NASD's automated quotations system for the over-the-counter market; with the National Clearing Corporation; and with new rule-making.

Yet, concern for investor welfare is not new to the Association. The NASD has always considered the promotion of "just and equitable principles of trade for the protection of investors" to be one of its major roles. As a self-regulator it can take a unique approach to this role. Because the Association's Board of Governors and standing committees are composed of individuals from the industry as well as certain needed outside experts, it can achieve the goal of investor protection without imposing unrealistic or unnecessary disruptions on industry operations.

With the development of NASDAQ and the National Clearing Corporation (NCC), the NASD has extended its role of serving investor interest beyond traditional rule-making and regulation. While 1971 was the year of NASDAQ, 1972 was the year of the National Clearing Corporation. The NCC was established in 1969 to implement a nationwide clearing network for over-the-counter securities. At the end of 1971, NCC had eleven firms in New York City involved in a pilot operation of its continuous net settlement (CNS) method of clearing. By the end of 1972, only one year later, NCC membership using CNS had grown to 290 firms in New York City, Boston, Philadelphia, and Chicago. A pilot operation connects NCC with the west coast. NCC's plans are to cover the country by the end of 1973. Already NCC is handling about 16,000 trades per day, speeding the settlement and delivery of securities for thousands of investors.

In the past year, the Association took on several difficult special assignments. The connecting factor in all these was the further safeguarding of investor interests.

Culminating a year and a half's study, the Association proposed rules setting maximum sales charges for mutual funds and variable annuities. The study and the resulting rules were assigned to the Association by Congress when it passed the 1970 Amendments to the Investment Company Act of 1940. When developing the rule setting a maximum for mutual fund sales charges, the Association tied the maximum permissible sales charge to the offering of services of value to the investor. The proposed rules, for both mutual funds and variable annuities, were distributed for comment last fall.

Early in 1972, the SEC directed the Association to design rules to prohibit a mutual fund's use of portfolio commissions as an enticement to encourage brokerage firms to promote the fund's shares. In its letter to the NASD, the Commission outlined several regulatory problems it felt could arise from this practice. Proposed rules were developed by mid-summer. After soliciting comments on the proposals, the Association redrafted the rules and submitted them to the membership for a vote late in 1972.

A second Commission request came in the summer, asking the NASD to consider additional regulation of new issues. The SEC was particularly concerned about hot issues—issues which trade at a premium immediately after coming to market. An NASD ad hoc committee, formed as a result of the Commission's request, has presented several recommendations, including: strengthened customer suitability requirements for certain types of new issues which are likely to be more speculative; requirements that members make a bona fide public offering in all new issues; a requirement that underwriters establish written procedures for conducting due diligence investigations; and the creation of a category of registration for "underwriter principals." The Association had been concerned about hot issues prior to the SEC request and has proposed special requirements for issues underwritten on a "best efforts" basis. These requirements would be aimed at those situations in which a restricted supply of stock has an undue effect on the issue's market price.

Comprehensive rules covering the distribution of tax sheltered securities were proposed by the Association in mid-1972. Because tax shelters are a product relatively new to the securities industry and, therefore, not specifically covered by many existing regulations, the NASD developed rules in response to the absence of sufficient oversight in this area. Some of the provisions of the proposals cover customer suitability, sales literature, conflicts of interest, and financial responsibility of sponsors. These rules will be submitted to the membership for a vote in 1973.

For nearly two years the Association has been developing a reconstructed system of determining the qualifications of securities industry personnel. It is a two-part program designed to make the examination and qualification procedure more relevant to actual job functions. In part one, which is approaching completion, the Association is developing new categories of registration to parallel actual job functions—initially: mutual fund/variable annuity salesmen, general securities salesmen, OTC traders, and operations principals. In part two, the Association will draw up standards for training securities industry personnel.

I believe the Association's activities during 1972 serve as microcosmic illustrations of its capacity to serve the investor with proficiency by drawing on the knowledge and ability of dedicated people from the industry. Ideally, the interests of both the investors and the industry can be furthered simultaneously. In the long run they are the same. The investor benefits from a smooth-functioning, efficient securities market. The market benefits from an investor population that is confident of the market's ability to serve it well.

Respectfully submitted,

Peter C. Barnes
1972 Chairman

President's Report

During the past year the prime topic of discussion within the securities industry and the organizations responsible for the regulation of that industry has been the future structure of the securities market. A considerable amount of study has been devoted to the form and composition of a central securities marketplace. The NASD, as the self-regulatory organization for the over-the-counter securities market, has participated actively in the discussion and study of this topic. We feel we have much to contribute to any future central market system. We have a nationwide regulatory capability, composed of 296 examiners and other personnel operating out of fourteen district offices throughout the country plus 156 people in the Washington headquarters employed in the regulation area. We have a nationwide quotations network, NASDAQ, which flashes current bid and asked quotations for OTC issues across the country in seconds. We have the basis of a nationwide clearing network, which will ultimately be capable of clearing trades from coast to coast. But, most importantly, we have a nationwide membership, covering all segments of the securities industry.

In 1972, the Association worked steadily to improve its regulatory capability, to refine and expand NASDAQ operations, and to extend the clearing facilities of the National Clearing Corporation. NASD efforts to improve its regulatory capability were marked by the addition of 92 people to the regulatory staff in 1972. Exhaustive studies by Association committees, staff, and independent consultants resulted in a variety of new recommendations and proposed rules. Comprehensive rules covering tax-sheltered offerings—an investment vehicle relatively new to the securities industry—were distributed for comment in mid-1972. Other new or proposed rules covered: sales charges for mutual funds and variable annuities; hot issues; mandatory bonding coverage for broker/dealers; and reciprocal business—mutual funds; rewarding broker/dealers with portfolio commissions for selling fund shares.

NASDAQ's second year of operation was one of steady growth. The number of stocks in the system increased from just over 3,000 at the end of 1971 to nearly 3,500 at the end of 1972. The number of calls (requests for quotations, etc.) per day continued to grow throughout the year, averaging over 1,150,000 daily by year's end. Although NASDAQ trading volume fluctuated, as did volume in other markets, it was about twice the volume on the American Stock Exchange and in excess of the total combined volume of all exchanges with the exception of the New York Stock Exchange.

Progress at the National Clearing Corporation has been rapid this past year. We are now serving over 250 New York City firms with the continuous net clearing system. We have opened regional operations in Boston, Philadelphia and Chicago through the facilities of the local stock exchanges in those cities. Additional firms are being added to the system from outside the New York area through clearing arrangements with major correspondent firms in New York. Expansion is being planned in such additional key metropolitan areas as Washington/Baltimore, Detroit/Cleveland, St. Louis and Dallas. Our target objective is to blanket the country by the end of 1973.

The NASD Board of Governors has authorized development of a daily trade reporting system, utilizing the NASDAQ system. These trade reports will be sent to the National Clearing Corporation. We were pleased with the recognition of our efforts recently received from the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce in its Securities Industry Study. The report said:

> The system which has thus far shown the greatest potential for accomplishing the certificateless trade is NASDAQ. Although at the present time NASDAQ is engaged solely in furnishing quotations for stocks included in the NASDAQ system as well as reporting trading volume in such stocks, it could be adapted to provide information on trades between NASDAQ subscribers. Such a system could bring about the locked-in trade which would execute, report and confirm trades as they take place and accomplish clearance and settlement. A substantial segment of the broker/dealer community already subscribes to NASDAQ. When NASDAQ is operated in conjunction with the National Clearing Corporation's continuous net settlement system for over-the-counter securities and a depository, the basic framework for a certificateless system will be in existence.

The securities industry is at a crossroads. We can look back over the changes that have taken place and the progress made towards strengthening the industry. But, more importantly, we must look forward to the changes that are coming. In the next two years the traditional ground rules of the securities industry will be rewritten. I believe that the NASD will have a hand in the rewriting as an integral part of the overall regulatory framework governing the securities industry.

Respectfully submitted,

Gordon S. Macklin

1972 – REPORT TO MEMBERS

1972 was a year of solid, steady achievement. NASDAQ grew in every measurable way—number of issues, number of terminals, amount of usage. The National Clearing Corporation expanded its operations in New York and then extended arms to Boston, Philadelphia and Chicago.

And it was a year of study and thoughtful analysis of problems facing the industry. The Association worked steadily to refine its ongoing programs, guided by its responsibility to provide the public and the industry with a fair and orderly marketplace.

REGULATION

The securities industry is fluid, constantly adapting itself to the changing capital needs of the nation's economy. Therefore, the NASD, as a regulatory organization, must continually re-evaluate its programs to ensure that they are in harmony with public and industry needs. In 1972 th s reappraisal resulted in several new or amended regulations. In addition the Securities and Exchange Commission adopted rules affecting NASD members.

Tax-Sheltered Programs

In recent years interest in tax sheltered investments has accelerated. Tax sheltered programs are so described because of the flow-through type tax benefits available to investors. Through this type of investment an investor can purchase an interest in a partnership or syndicate which then invests in a particular product—such as real estate or oil and gas drilling. Significant to the NASD, however, was growing member involvement in distribution, management, or sponsorship of tax sheltered investments.

Proposed new controls were circulated for comment in the summer. After a period in which all comments were considered and efforts were made at coordination with certain industry groups, such as the Oil Investment Institute, National Real Estate Board, and Real Estate Securities Institute, as well as governmental and state regulatory authorities, the rules and regulations have been submitted in final form to the Board of Governors for adoption with circulation to the membership for a vote to follow.

A key provision in the proposals establishes strong customer suitability standards, which vary somewhat depending on the type of tax sheltered investment. The general standards cover underwriting terms and arrangements and other relevant factors concerning the distribution of tax sheltered programs to the public, including all items of compensation to be paid to sponsors or broker/dealers and the terms and conditions concerning the operation, structure, and management of the programs. Provisions also relate to conflicts or potential conflicts of interest of sponsors. Additional provisions will establish standards of knowledge, experience and financial responsibility for sponsors or managers of these programs.

Broker/Dealer Self Underwriting

Recognizing the need of the securities industry to obtain capital through modern financing methods, the NASD acted to permit its members to underwrite offerings of their own securities. In March the Association established rules and procedures for members to follow when distributing their securities, whether independently or self-underwritten. Experience with these regulations demonstrated the need for minor clarification of the rules and the addition of some new features. Amended rules have been released to the membership for comment.

An important provision of the amended NASD rules, if adopted, would require the election of a public representative to the Board of Directors of any member making a public offering of its own securities. One of the responsibilities the public director would be to serve as chairman of an audit committee.

Hot Issues

The market upswing, which began in 1971, rekindled the Securities and Exchange Commission's concern over sudden fluctuations in prices of some new issues, particularly those of a highly speculative nature that are often brought to market as "best efforts" underwritings. Commission hearings, held in 1972 to examine forces behind this phenomenon, led to an SEC request that the NASD review its rules and further define them in three main areas: (1) developing stronger customer suitability standards for new issues; (2) broadening current rules requiring underwriters to make a bona fide public distribution; and (3) establishing due diligence guidelines and underwriter standards.

An Association Ad Hoc Committee to Study New Issue Rules, formed as a result of the Commission's request, has recommended greater controls over the sales of new issues to the public. The committee recommended to the NASD Board that: (1) the Association's customer suitability rules be amended to cover first time offerings of companies in the promotional stage; (2) a rule be implemented to require written procedures to be established and followed by underwriters in conducting due diligence investigations; (3) a new category of qualification and registration for broker/dealer personnel be established for "underwriter principals"; and (4) the Association regulations stress a member's obligation to make a bona fide public offering in all new issues. The committee is also considering special regulation of "best efforts" offerings, an area which was the subject of an earlier Association proposal.

Mandatory Bonding Coverage

A proposal to authorize the Board of Governors to require NASD members to obtain blanket fidelity bonding coverage was submitted to the membership for a vote at the end of the year. Every member who is required to join the Securities Investor Protection Corporation and who is subject to the SEC Net Capital Rule would, under the proposal, be required to maintain bond coverage of at least $25,000 to cover employees. The proposal, which would cover customer losses sustained through such activities as fraudulent trading, misplacement of securities, or forgery, is designed to supplement the protection to customers provided by SIPC. The proposal would also authorize the Board to alter the bonding requirement from time to time.

Reciprocal Business

The practice of mutual funds' rewarding broker/dealers for selling fund shares with portfolio brokerage commissions would be prohibited by a rule sent to NASD members for a vote late in the year. The rule seeks to end this practice, sometimes known as reciprocal business, by prohibiting members from favoring or avoiding a particular fund on the basis of portfolio brokerage business expected or received. Under the rule, members may not demand portfolio brokerage as a condition to selling a fund's shares. The Association developed the rule at the specific request of the SEC which cited several potential regulatory problems which it felt could arise from the use of reciprocal business.

Mutual Fund and Variable Annuity Sales Charges

Mutual fund and variable annuity sales charges were the subject of two proposed NASD rules released for comment in November. The rules were based on conclusions of a year and a half study of distribution of these securities.

The study and the concomitant rules were mandated by the 1970 amendments to the Investment Company Act of 1940 which gave the NASD the task of preventing excessive sales charges while providing reasonable compensation for sales personnel, broker/dealers and underwriters. To avoid industry bias, the independent consulting firms of Booz, Allen & Hamilton, Inc. and Foster Associates, Inc. were retained to conduct the study.

The proposed rules would set the maximum sales charge on mutual fund shares at 6% if the fund does not offer three specified services to investors: (1) rights of accumulation (cumulative quantity discounts); (2) reinvestment of dividends with no sales charge; and (3) discounts for large purchases. From the 6% base, the sales charge would be permitted to increase, depending on the combination of services offered, to a maximum of 8½%. Variable annuity sales charges would also be held to a maximum of 8½% with sales charge reductions for large single purchases.

Municipal Securities

Evidence of misrepresentation and manipulative practices in municipal bond transactions prompted the NASD to appoint a committee last May to consider regulation of municipal bond dealers. These activities have not been closely regulated because municipal bonds are generally excluded from federal oversight as exempt securities.

The committee, which includes representatives from banks and municipal bond houses, is considering several alternative regulatory approaches, including full regulation by the NASD, regulation by the SEC, regulation by an independent organization formed especially for that purpose, regulation by the Federal Reserve Board, or regulation by a combination of agencies.

The committee agreed that the municipal bond industry would benefit greatly from more uniform operational procedures, especially a central clearing facility.

Third Market Rules and Disclosure

On February 2, 1972, the SEC announced plans for restructuring the nation's securities markets. Special SEC advisory committees immediately began work to decide how to structure and implement the plan's major proposal—establishing a central market system for all exchange listed securities.

Because trading of some listed issues occurs in the over-the-counter market (the so-called Third Market), part of the problem is to incorporate the reporting of these transactions in listed issues into the distribution of information within the central system. Recommendations of industry committees, an NASD committee (the Third Market Disclosure and Rules Committee, formed to study the problem), and the SEC Advisory Committee on Market Disclosure were considered by the Commission when adopting Rule 17a-15.

Under the rule, last sale price and volume information on all listed securities could be made available through a vendor of market information. The NASD and the exchanges were required to submit a plan to the SEC for the dissemination of this information. Once the plans are approved by the Commission, the NASD and the exchanges will have 40 weeks for implementation.

Net Capital Rule

Capital requirements for non-exchange securities firms were strengthened in July of 1972 by the Securities and Exchange Commission. A new amendment to SEC Rule 15c3-1 requires a maximum net capital ratio of 8 to 1 for the first twelve months of existence of any broker/dealer who became registered after August 13, 1971. All such broker/dealers are also required to maintain a minimum net capital of $25,000. Those firms which became registered before August 13, 1971 must have a minimum net capital of $15,000 by July 31, 1973 and $25,000 by July 31, 1974.

A $5,000 minimum net capital is permitted for those broker/dealers who clear transactions on a fully disclosed basis through another member and do not otherwise hold customer funds or securities. The new amendment does not change the requirement for those broker/dealers entitled to a minimum net capital of $2,500.

Late in 1972 the Commission proposed to adopt a uniform net capital rule for all broker/dealers, removing the exemption currently enjoyed by members of national stock exchanges. The proposed amendents to Rule 15c3-1 would establish six categories of securities firms with varying minimum net capital requirements. With the exception of new firms in their first year of operation, all broker/dealers would be required to maintain a ratio of indebtedness to net capital of no greater than 15 to 1. Other proposed revisions include: deductions from net worth for undue concentration in certain securities; a minimum term of 3 years before withdrawal of subordinated loans from insiders—2 years for contributors not associated with the firm; and a requirement that at least 30% of a broker/dealer's capital be in the form of equity.

Customer Protection Rule

In November the SEC released the final version of Rule 15c3-3—Customer Protection-Reserve and Custody of Securities. The Commission's objective in this rule is "the elimination of the use by broker/dealers of customer funds and securities to finance firm overhead and such firm activities as trading and underwriting" by separating customer-related activities from other broker/dealer operations.

To achieve this objective, the Commission, with counsel from the industry, designed a two-part rule. The first redefines a broker/dealer's obligation to promptly obtain possession or control of customer's fully-paid and excess margin securities. The second is a requirement that broker/dealers maintain a Special Reserve Bank Account for the benefit of customers in an amount equal to the total of all funds which have customers' assets as their source (i.e. customers' credit balances held by the firm or cash realized through the utilization of customers' securities), minus customer-related debits.

In order to familiarize NASD firms with the new requirements, more than 40 separate seminars were held in cities around the country. In addition the field examiner force visited several hundred firms to give personal instruction.

Corporate Financing Review

Public offerings of securities in which members intend to participate are reviewed by the Association to determine whether the underwriting terms and distribution arrangements are fair and reasonable. Last year 2,886 offerings were filed, representing a total of $22.3 billion, up from 2.594 offerings filed in 1971. Tax sheltered offerings reviewed grew more than 25% from 405 in 1971 to 539 in 1972.

The Association has expanded its corporate financing review activities into the areas of corporate investments, tax sheltered programs, public ownership of broker/dealers and affiliated companies, and hot issues. The Assocation continues to maintain close working relationships with federal and state authorities and certain other groups in an effort to coordinate and establish better regulatory controls for the benefit of the public and the industry.

Advertising Review

Sales literature and advertising for both general brokerage firms and investment companies are reviewed by the Association to ensure that they are not misleading, and that they conform to NASD rules and various SEC requirements. In 1972, 12,000 pieces of literature were filed for Association review or comment.

Liberalized SEC requirements, first proposed late in 1971, were adopted in 1972. Essentially, the rules permit "tombstone" advertisements to include offers, descriptions, or explanations of any product or service not constituting securities, and descriptions of corporations (including investment advisors) and their activities. However, these offers, descriptions or explanations must not directly relate to the desirability of owning or purchasing a security. The rules also permit generic advertisements which do not specifically refer by name to the security of a particular investment company. Such an advertisement, however, must be limited to explanatory material relating to investment companies or offers of various products and services not constituting a security.

Variable Contracts

The number of life insurance companies or their subsidiaries joining the Association continues to increase but at a slower rate than that of a few years ago. However the number of registered representatives holding life insurance licenses continues to mount. This trend results from continued registrations of more full-time agents of insurance companies who are already members and from the stock exchanges' relaxing prohibitions against members selling life insurance.

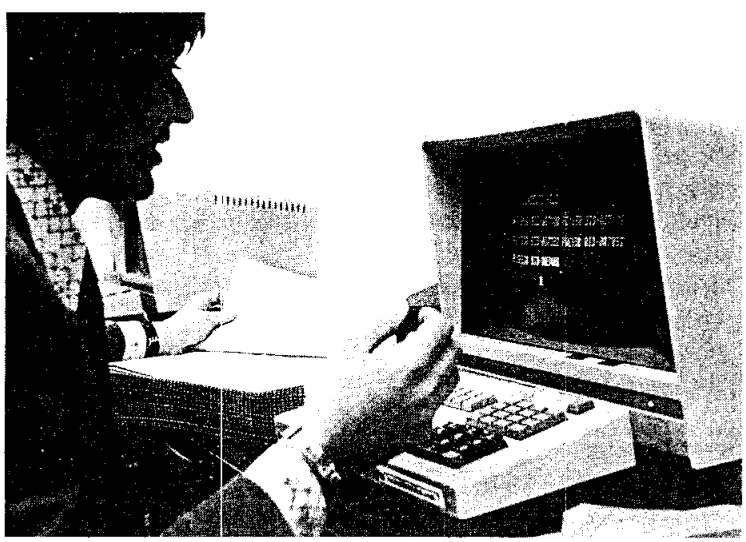
Several years ago the variable annuity was judged by the Supreme Court to be a security subject to federal regulation. As a result, many leading insurance companies joined the Association and registered salesmen selling variable annuities. Recently certain insurance companies developed a new life insurance policy known as variable life insurance. The new policy is designed to pay a minimum guaranteed death benefit equal to the face amount, but the actual death benefit could be greater depending on the performance of an underlying portfolio of common stocks in which the reserves would be invested.

The insurance industry trade associations petitioned the SEC to exempt variable life insurance from federal securities regulations, arguing that it is predominantly an insurance vehicle. On January 31, 1973, the SEC ruled that: (1) variable life contracts are securities and must be registered with the SEC; (2) those selling these contracts must register as broker/dealers; (3) these contracts are defined as investment companies, but are exempted from the regulatory requirements for investment companies; and (4) insurance companies issuing these contracts are investment advisers, but are exempted from the provisions of the Investment Advisers Act. It appears that the Association will be required to assume the regulation of the sale of this product by its members.

Examination of Member Firms

Although NASDAQ and the National Clearing Corporation have enhanced the Association's regulatory capability, surprise examinations of member firms continue to be a key regulatory tool.

4,509 examinations of members were conducted in 1972, including 3,002 regular and special examinations of main offices. Primarily as a result of these examinations, 374 formal complaints were filed. In addition 94 summary complaints, the procedure for handling minor or technical infractions, were filed. 1972 disciplinary actions resulting in the expulsion of 44 firms, the barring of 122 individuals, and the suspension of 42 firms and 105 individuals.



Market Surveillance

The NASDAQ market surveillance program was initiated by the Association to insure that the NASDAQ system would carry with it sufficient regulatory procedures to protect and promote a fair and orderly marketplace. The data generated from NASDAQ provides an unprecedented vehicle for conducting OTC market surveillance.

Each evening the NASDAQ computer analyzes all quotations changes and volume entries and measures them against parameters programed into the system. Every security exceeding these parameters appears in a report together with trading information. This report is received on printer terminals in the Association's Washington office before the market opens the next day.

Specially trained analysts keep constant watch on trading patterns of NASDAQ securities and conduct investigations to determine the causes of significant deviations from normal behavior. When an unusual trading situation develops, the staff immediately begins to track down enough facts to gain a clear understanding of the problem. Each analyst devotes the greatest portion of his time to the collection and assembly of data from members about their involvement in the questioned situation.

The market surveillance effort is designed to pinpoint possible trouble areas. If irregular market activity is uncovered, the analysts prepare a summary of their investigation for referral to the proper authority. This program is coordinated with the Association's regular examination efforts, the financial reporting program and the regulatory information generated by the National Clearing Corporation.

MEMBER SERVICES

The Association supplements its standard regulatory activities with services that enable its members to function more efficiently and effectively and information that helps the public in understanding the OTC market. As the public interest is the key to the Association's regulatory programs, so is it the key to its service efforts.

NASDAQ

A major service is NASDAQ, the NASD's automated quotations system for over-the-counter securities. NASDAQ began operation on February 8, 1971, transforming a loosely-connected OTC market into a sophisticated communications network. Comprehensive indices and trading volume figures, reflecting OTC market activity, are available through NASDAQ.

With the second anniversary of NASDAQ, it can be fairly stated that the system has been a success in reaching its original objectives—giving the OTC market an automated quotations system. NASDAQ now provides immediate access to current representative bid and asked quotations in OTC issues throughout the world. In addition to the 25,000 Level I terminals providing representative quotes to U.S. users, 1,027 terminals provide the same infomation to users in other countries.

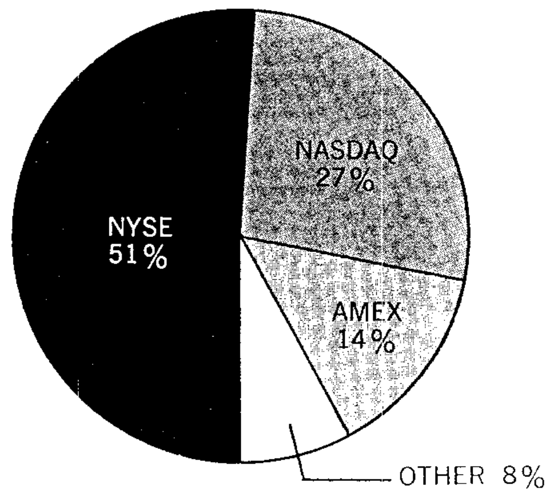
Reliance on the system continues to exceed pre-NASDAQ expectations. A new high for daily calls (requests for quotes, indices, volume, etc.) was set in May—1½ million. During peak periods, such as market opening, the system may handle 100 calls per second. There are 1,685 Level II and III terminals hooked into the system. Level III's are used by market-makers to put their quotations into the system. Level II's display all market-maker quotations for any NASDAQ issue.

Adding an average of ten issues a week during most of 1972 has brought the total number of NASDAQ securities to 3,500. These issues are represented by nearly 23,000 market-making positions, an average of six to seven market-makers per security.

Exchange listed securities with two or more NASDAQ market-makers are eligible for inclusion in NASDAQ. The NASD Board's final decision to add qualified listed issues was made after reviewing a study of 10 month's experimental inclusion of listed securities.

In a related area, the Board also voted to permit qualified exchange specialists who are NASD members to put their quotes on NASDAQ. Beginning in May, quotations of two specialists on the Philadelphia-Baltimore-Washington Stock Exchange began appearing on NASDAQ terminal screens. In August, the bid and asked quotes of two National Stock Exchange specialists were added to NASDAQ.

Trading Activity on NASDAQ and Exchanges



Shares Traded

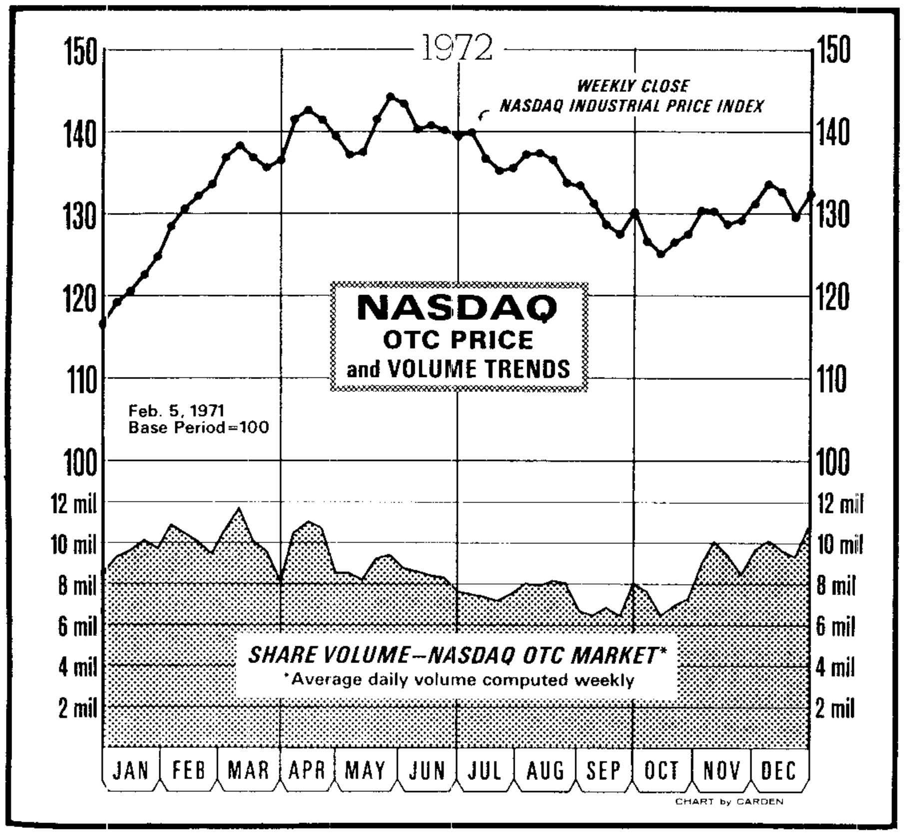
NYSE	4,138,187,706
NASDAQ	2,209,548,500
AMEX	1,117,971,382

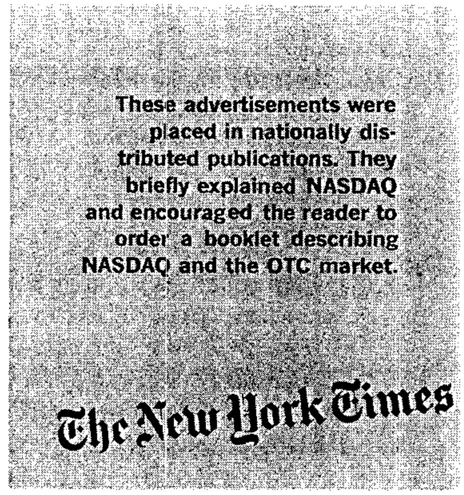
In 1972 trading volume on NASDAQ was greater than the combined volume of all other exchanges, with the exception of the New York Stock Exchange. NASDAQ volume totaled over half the volume of NYSE.

The NASDAQ receiving network was expanded in April when non-members were permitted to subscribe to Level II service. This action gave them direct access to all bid and asked quotations in NASDAQ issues. Chief potential beneficiaries were institutions, such as banks, insurance companies, mutual funds and pension plans.

Nationwide access to current, accurate quotations encourages a competitive marketplace; and the Association believes competition is the best regulatory tool available. However, some rules have been necessary to insure the integrity of NASDAQ. In the first year of operation a rule was instituted requiring market-makers to trade at least a normal unit of trading (usually 100 shares) at their current NASDAQ quotations, upon request of another member. Market-makers are also required to report each day's purchases and sales in all issues in which they make a market. Some fines have been imposed for violations of these rules.

To aid the Association in judging complaints against NASDAQ market-makers for backing away





Trading in securities carried on NASDAQ averaged more than 8.5 million shares per day in 1972. A record 14.3 million shares was reached on December 29. The NASDAQ industrial index experienced a 13.6% rise in 1972.

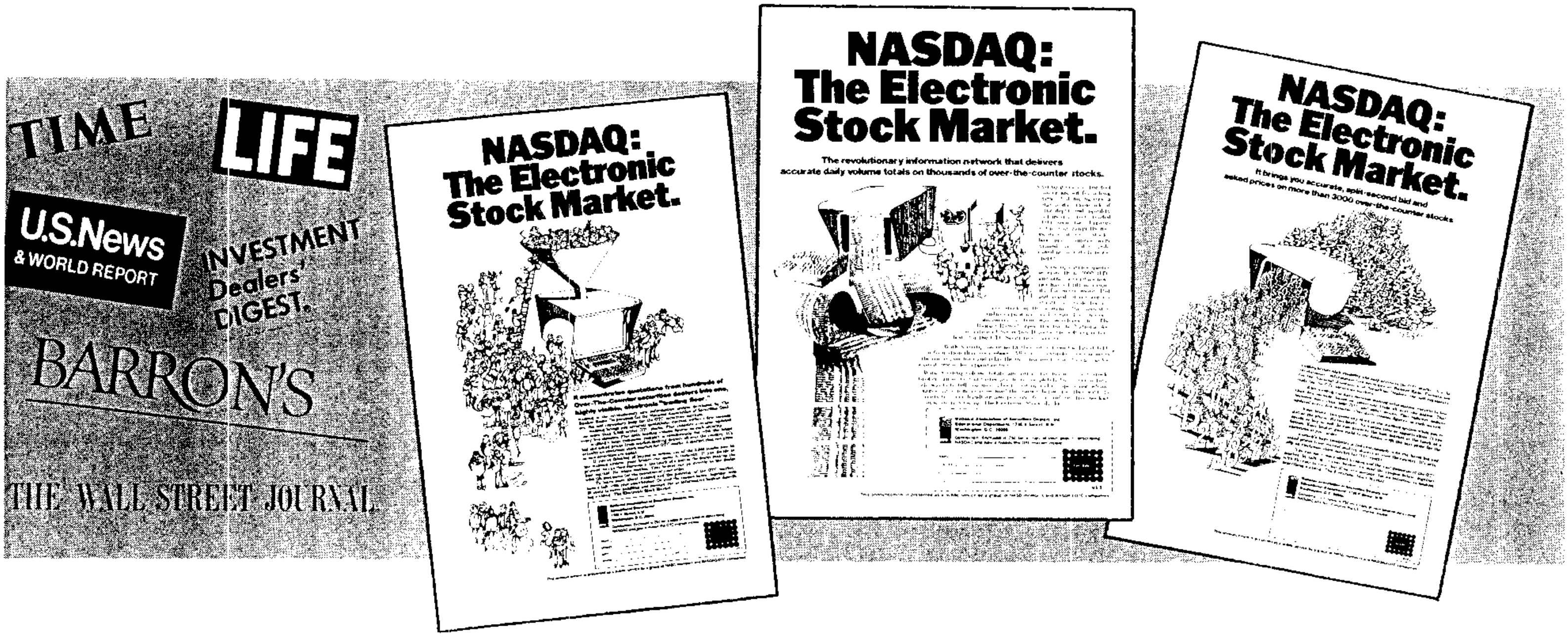
from their quotations, a NASDAQ time and date were made available on the terminals. All members are expected to interrogate the system each morning for the NASDAQ time and to set clocks used for time-stamping of tickets.

Stronger rules covering market-makers' temporarily withdrawing their quotations from the system were instituted in late November. The Association observed a few market-makers withdrawing quotations whenever a sudden movement in a security's price occurred. The new rules require NASDAQ market-makers to obtain an "Excused" status from the Association when withdrawing a quote. Failure to do so may result in disciplinary action against the offending market-maker.

Investors, corporate issuers, researchers and analysts all benefited when NASDAQ produced, for the first time, a variety of stock price indices, broken down by industry groups, and information on the volume of NASDAQ trading activity. Investors now are able to fully study the market performance of OTC stocks.

Now that the relevant information is available to the public, the Association is working to obtain more flexible margin privileges for NASDAQ stocks. Although exchange listed stocks are automatically eligible for margin, only specified OTC issues are eligible under the margin rules of the Federal Reserve Board. And the margin standards for OTC issues are higher, in many instances, than the listing requirements of the exchanges. Seeking to correct this unfair situation, the NASD has computerized a six-month data base of relevant facts on NASDAQ companies and will relay information weekly to the Federal Reserve Board staff. Eventually, the NASD seeks equal treatment of NASDAQ stocks with listed stocks under the margin rules.

In 1972 the Association became particularly aware of the interest of foreign investors in NASDAQ issues—an interest that is partially hampered by the laws of many countries which restrict their citizens' purchases of American securities to those listed on stock exchanges. Recognizing that these laws resulted from



differences in marketplaces that, for the most part, no longer exist, the Association is anxious to eliminate such barriers.

NASDAQ-OTC Education Program

Members of Congress, the Securities and Exchange Commission, and the securities industry have recognized NASDAQ as a giant step in harnessing technology to streamline the operations of the OTC market. However, the prime beneficiaries of NASDAQ, the investing public and companies whose stock is traded OTC, were in an informational vacuum. In 1971, the Association launched a program to fill the void—not only in information about NASDAQ, but about the OTC market in general. Most of the educational effort in 1971 consisted of encouraging the appearance of articles in national newspapers and magazines about NASDAQ and the OTC.

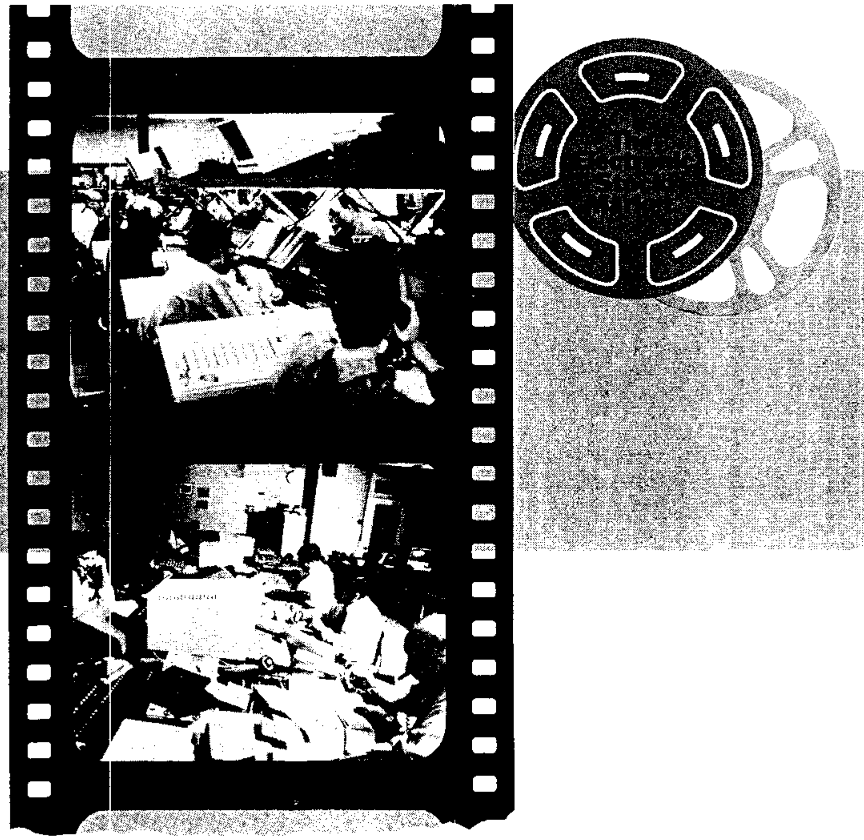
In February of 1972 the Association began an institutional type advertising program with the theme, "NASDAQ—The Electronic Stock Market." Ads were run in national publications having the largest possible circulation to potential investors and corporate businessmen. Life magazine, Time, The Wall Street Journal, U.S. News and World Report, Barron's, Institutional Investor, Investment Dealers' Digest and the New York Times carried the educational advertisements throughout the spring and fall of 1972.

Each of the three ads used carried a coupon for the reader to request a new booklet entitled, "NASDAQ & the OTC" which provides detailed information about the market. These ads spurred more than 10,000 individual requests for this publication, which is also available in quantity for distribution by broker/dealers and for use in company investor relations programs. Members have ordered 150,000 copies in 1972 for distribution to their customers.

A second, more sophisticated publication is in the final stages of preparation and will be available in the first part of 1973. This publication will analyze the role NASDAQ can play in the age-old corporate decision—"Where is the best market for my company's stock—over-the-counter or on an exchange?"

Augmenting this public exposure to the over-the-counter market is a public information effort to inform and educate financial editors, newscasters and magazine feature writers about the continuing developments and significance of NASDAQ. The OTC Information Bureau has been established in New York City in cooperation with the National Security Traders Association. This office regularly handles requests for statistical and research information on the OTC market from magazines, newspapers, analysts, educators and almost every segment of the business community. As a result of this effort, market summary stories in newspapers that previously ignored the OTC market are now featuring this important segment of the industry far more prominently.

The Association is preparing a packaged seminar program on NASDAQ and the OTC



This 13½ minute color film not only shows how the OTC market works, but stresses the significance and application of NASDAQ and the improvements it has brought to all those concerned with investing in stocks.

market. It is designed for use by account executives in brokerage firms to present accurate and detailed information on the OTC market in conjunction with an audio visual format. Proposed uses for the seminar program are: investment club meetings, customer relations, and community groups. The package will include script, slides and instructions for promoting such an event.

Now in distribution is a 13½ minute color motion picture film entitled "The Electronic Stock Market", which presents NASDAQ and the OTC market in a documentary style, using actual individuals from the securities industry and offices of OTC companies on NASDAQ. Since it was released in October, the film has been shown over 500 times. While most of the requests for the film have come from NASD members, for customer relations, and from companies with securities listed on NASDAQ, for viewing by corporate executives and stockholders, the film has been shown extensively to schools and universities. The Association is also distributing the film to educational television stations and other local TV outlets for use on financially oriented shows. Although the NASD is currently lending copies of the film at no charge, over 30 copies have been sold, including one copy each to securities organizations in Japan and Brazil. Response to the film has been extremely favorable.

Press Relations

The over-the-counter stock quotations tables that are carried in the financial sections of many newspapers across the country underwent significant revision on January 3, 1973. Under a plan approved by the SEC, the geographic stockholder criteria for listing companies in the National OTC stock tables was replaced with inclusion standards primarily designed to reflect investor and reader interest. The new list is, therefore, composed of the most actively traded issues of the approximately 3,500 securities in the NASDAQ system. Companies with a demonstrated, sustained high volume of trading now receive broad exposure.

The NASD supplies the major wire services each day with closing quotations and volume information on all the securities in its system which are then edited by the wire services based on volume criteria into a National List of 1400 issues for distribution to approximately 30 large metropolitan newspapers.

The 1400 stocks with the highest average weekly volume are designated the "Most Active National List." The composition of this list will be redrawn every six months to enable other qualified NASDAQ companies to gain inclusion. Also available is a second "Supplementary National List", composed of the next 900 stocks in the volume ranking. Newspapers are being urged to carry this group of stocks with bid and ask quotations only, so that they can be set in a half column measure to accommodate space limitations. This list will be recomputed every two months.

Coverage of issues with regionalized reader interest has not been neglected. The Association is coordinating the activities of local quotations committees to supply newspapers with closing quotations and volume figures on OTC issues of local interest.

Economics

Meaningful data along with interpretation and analysis are vital to the Association to formulate policy or develop new rules. This information is supplied by the Association's staff of economists. When the Association was told by Congress to set "reasonable" sales charges for mutual funds and variable annuities, it undertook a massive study of the distribution of these securities. The proposed rules resulted from the independent consultants' interpretation of the data collected by the Association. The decision to include qualified exchange listed securities on NASDAQ was also based on a study by the Association's economists of the impact of experimental inclusion in NASDAQ of listed issues.

The Association is now concentrating on the interpretation of the data received from various sources (NASDAQ, financial reports, etc.) to provide its members and the public with pertinent statistics about the OTC market. In its first industry-wide study, the Association determined that 1971 member earnings experienced a sharp recovery from the depressed level of 1970, particularly in OTC activities. The following table shows selected sources of revenue for 1970 and 1971.

GROSS INCOME ITEM	1970	1971	Percent Increase 1971 over 1970
	(Millions of dollars)		
Exchange Commissions	2,009	2,817	40.2
OTC Agency Transactions	289	433	49.8
OTC Principal Transactions	452	707	56.4
General Underwriting	463	768	65.9
Exempt Debt Securities	569	633	11.2
Other Income	1,312	1,436	9.5
Total Gross Income	5,094	6,794	33.4

SYSTEMS

The Association's in-house staff of automation personnel has been instrumental in the development of technical enhancements to the NASDAQ system. A significant enhancement in 1972 was the appearance of same day volume statistics on NASDAQ Level II and III terminals. The day's trading volume for every security with two or more market makers can be received on the terminals from 4:35 PM to 6:30 PM. The previous day's volume is available from 9:00 AM to 9:55 AM Eastern Time. Displayed with volume figures are the issue's closing representative bid and asked quote and the week-to-date volume.

Now under consideration is the addition of an automatic execution capability to the NASDAQ system. Two developments to NASDAQ would be necessary to realize this. First the system would have to be altered to allow a market maker to indicate the size of his market along with his quotations. Secondly, a capability would be incorporated into the system to permit the market maker to indicate his willingness to participate in an automatic execution. Ultimately, a buyer would be able to check his terminal for a market maker's quotations, size of market, and willingness to trade automatically. If all three indications are present and acceptable, the buyer could punch a few buttons, and instantly the trade would be executed without voice contact with the market maker.

The Association continues to explore possible new uses for NASDAQ, with primary emphasis on improving the market for the investor and cutting down on costs for the over-the-counter community. One possibility is a batch-type trade reporting system using NASDAQ terminals. Through such a system, firms throughout the country could enter the specifications of their completed trades through their NASDAQ terminals. This information would be immediately validated and subsequently transmitted to the National Clearing Corporation for comparison and clearing.

A second possibility under study is a nationwide message switching system, either using NASDAQ or separate computers. In addition to allowing firms to report trades, the system would also allow any member to communicate messages to any other member, to banks, to NCC, to depositories, to the NASD, or to transfer agents.

Another future prospect for NASDAQ is an automatic dial-up system that would enable any NASDAQ subscriber to obtain a private telephone connection with the market maker of his choice simply by depressing two or three keys on his terminal keyboard.

Although the Association's staff of computer analysts provide in-house technical ability to monitor NASDAQ's performance and to help in planning NASDAQ's future, they also serve other areas of NASD activity. The automation staff programmed and processed the data for the mutual fund study, the third market study, and other statistical studies. Some of the areas in which automation has streamlined NASD operations are: (1) the collection, processing, and storing of annual and quarterly financial report data; (2) processing monthly financial information from the New York and American Stock Exchanges about joint exchange/NASD members; and (3) determining member assessments directly from the yearly financial reports, eliminating separate assessment reports. Work is underway to automate membership and registration records.

The NASD's growing need for computer processing warranted the establishment of an in-house data processing facility. In mid-September, an IBM 370/145 was installed in the NASD's building in Washington, D.C., and was operating smoothly by the end of the month. This facility services both the NASD and the National Clearing Corporation.

The Association's in-house data processing facility, an IBM 370/145.

ADMINISTRATIVE SERVICES

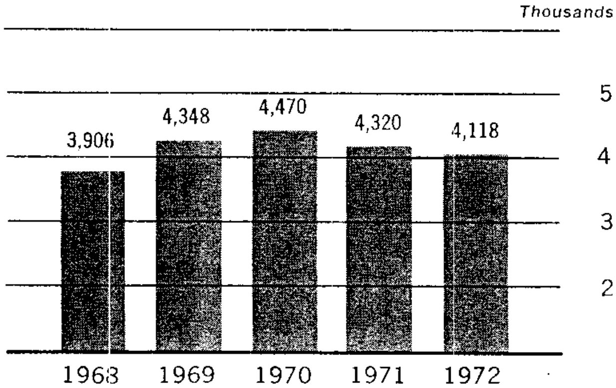
Providing the regulatory guidance for an industry as geographically dispersed as the OTC market requires an efficient administrative structure. This is the mission of the Administrative Services Group—boosting the productivity of the Association's 550 employees located in the National headquarters and 14 district offices; ensuring the efficient handling of the records of 4118 members and 201,805 registered representatives; and administering the system of qualification of securities industry personnel.

Re-organization

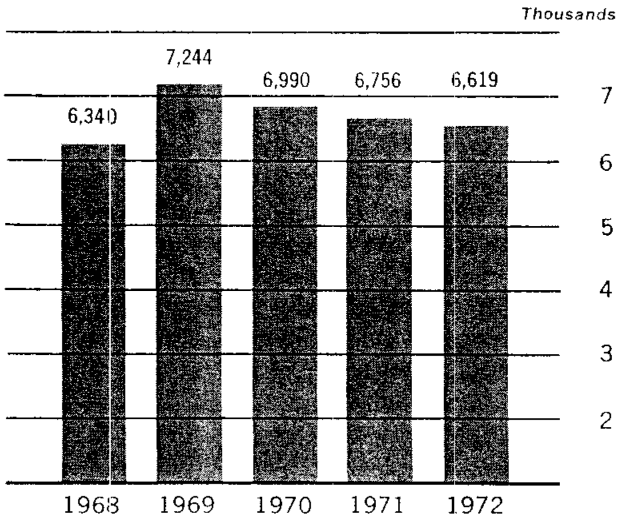
To facilitate the work flow and distribute the decision-making responsibility, the Board of Governors, in July, divided the Association's operations into five Groups, each headed by a senior executive. Collectively they function as the Senior Management Group responsible to the NASD President. The re-organization is designed to streamline the Association's handling of its expanded regulatory functions and services to members. The 5 Groups are: Regulation; Member Services; Systems; Administrative Services; and Legal and Government Relations.

1972 Statistical Review

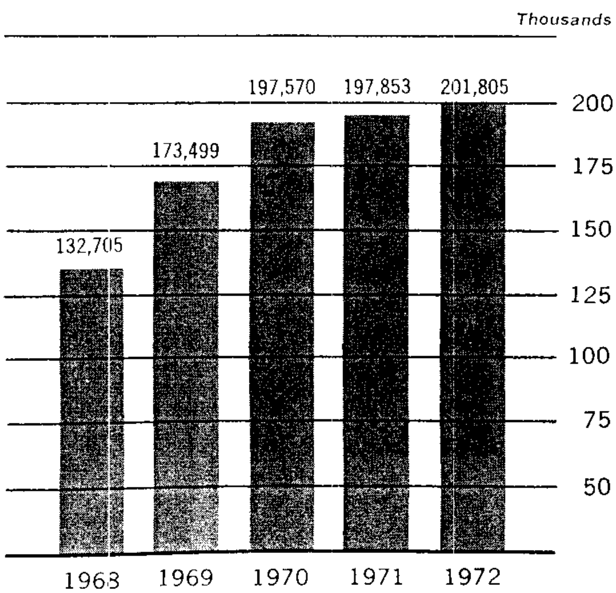
MEMBER FIRMS



BRANCH OFFICES



REGISTERED REPRESENTATIVES



EXAMINATIONS ADMINISTERED BY THE NASD FOR THE FIVE YEAR PERIOD BEGINNING

January 1, 1968 and ending December 31, 1972

YEARS	QUALIFICATION EXAMS FOR NASD	EXAMS ADMINISTERED FOR OTHER INSTITUTIONS	TOTAL
1968	58,561	31,342	89,903
1969	66,748	35,288	102,036
1970	63,653	26,862	90,515
1971	32,366	21,696	54,062
1972	38,519	26,262	64,781

Membership

The number of Association members decreased slightly in 1972. This was primarily due to a decrease in new member application. The 521 terminations of membership in 1972 are somewhat less than the 541 that terminated in 1971.

Branch offices are also down slightly from the year before.

Yet, despite the decrease in membership and branch offices, the number of registered representatives continues to increase.

Qualifications

Anyone applying for registration as a securities salesman (registered representative) or as a principal (management personnel of a broker/dealer) must pass the appropriate examination. In 1972, 38,519 NASD examinations were given in test centers throughout the country. Another 26,262 registration examinations were administered by the NASD for other organizations, such as the stock exchanges and some states.

More than 2 years ago, the NASD launched a program to upgrade standards of professionalism among registered representatives and principals. A consultant's study of job training and requirements led the NASD Board to decide that: (1) qualification examinations should test an applicant's ability to perform actual job functions; (2) the Association should initially develop job-based qualification requirements for 4 categories (mutual fund/variable annuity salesmen, general securities salesmen, operations principals, and OTC traders); and (3) the qualification program should be extended to include standards for industry training programs.

The Association set up an Industry Task Force to develop descriptions of detailed performance requirements for each of the 4 categories. This task force, composed of individuals from member firms and other regulatory bodies, had nearly finished its assignment by the end of 1972.

Beginning in early 1973, with the mutual fund/variable annuity category, the job descriptions—or analyses—will be sent to a representative portion of the membership for comment. Replies, combined with NASD staff and Task Force recommendations, will provide the basis for the final content of new qualification standards.

Once the job analyses are validated, the Association will specify entry and advanced levels of qualification. Following an analysis of the impact of the new qualifications on the industry, the Association will develop standards for industry training programs.

A step toward defining qualification standards for personnel in a broker/dealer's internal management structure was taken in September. The Association established a new category of registration—"Financial Principal". All new members must appoint a Financial Principal, who is to be responsible for the firm's general financial condition. Prospective new Financial Principals must pass both the examination for principals and an examination for financial principals.

Arbitration

Approximately 3 years ago the Association instituted a program, which has provided a forum for both the public and the members alike, for the voluntary submission of securities transactions disputes to arbitration. During the past year the program has been transformed in 2 major respects. First, mandatory arbitration began on March 9, 1972. Consequently, the arbitration of certain disputes arising on or after this date is now required upon request of either party. Controversies arising before March 9, 1972, will continue to be arbitrated only when all parties voluntarily agree to arbitration.

The Arbitration Code has, in addition, been amended to permit the arbitration of certain non-securities disputes. This combined effect of mandatory arbitration and the amendments dealing with non-securities disputes now allows the Association to provide a complete arbitration service.

Financing the NASD

The proliferation of new regulatory programs—among them regulatory oversight for NASDAQ; new responsibilities given to the NASD by Congress and the SEC; and the hiring of more personnel to deal with new products and types of business within the industry—has increased the Association's operating expenses.

Because of these additional financial commitments, the expenses for the 1973 fiscal year have been projected at $2,350,000 above last year. Anticipating a decline in some revenue sources, the Board of Governors of the Association increased the basic assessment for each member from $85 to $150 and increased the gross assessment rate from 0.2% to 0.21%. The return to a $150 basic assessment restores this factor to the amount in effect in the years preceding 1966. This level is more commensurate with the cost of servicing and regulating the smaller Association members. Effective for the calendar year 1972, the Annual Assessment Report was eliminated by integrating the information required into the Introduction portion of the Annual Financial Report—Form 17A-10.

LEGAL AND GOVERNMENT RELATIONS

In June of this year the Securities and Exchange Commission ruled on a question concerning Section 25 of Article III of the Association's Rules of Fair Practice. The question and subsequent SEC proceeding was instigated in 1970 by a non-member who wished to distribute its products through members. Under Section 25, the Association was prohibiting members from joining with non-members in any distribution of securities and from receiving any concessions from non-members.

The June 7, 1972, Commission order stated that Section 25 was "abrogated to the extent that it permits or has been construed to permit the Association to bar a member's receipt of commissions, concession, discounts or other allowances from non-member brokers or dealers . . ."

The NASD sought to have the order stayed, pending requested clarification by the SEC or a subsequent appeal. When this request was denied, the Association notified the membership that its interpretation of Article III, Section 25, would be altered according to the Commission order.

The Association's appeal of the Commission's order to the United States Court of Appeals is currently pending. Due to the importance and complexity of Section 25, the application of the SEC's interpretation is being considered by the Association on a case-by-case basis.

Government Relations

The Association functions as the voice of the over-the-counter securities industry in Washington. As such, representatives from the NASD appeared at hearings held by the Securities and Exchange Commission as well as panels in both the U. S. House of Representatives and Senate.

The SEC initiated hearings late in February to investigate the "hot issue" phenomenon with an eye toward curbing speculative problems before they develop or preventing entirely practices that encourage unwarranted demand for new offerings of questionable quality. Representing the NASD at these hearings was J. Logan Burke, an officer of W. E. Hutton, Inc., Chairman of the Association's Corporate Financing and National Business Conduct Committees, and 1973 Chairman of the Board of Governors. Mr. Burke reviewed the Association's regulatory acitvities in the area of new issues, emphasizing the NASD's proposed rule covering "best efforts" underwritings. He urged the Commission to distinquish between the legitimate and questionable forces that spur immediate price increases for some new offerings, noting that an immediate increase in price is not necessarily improper by itself.

February hearings held by the House Subcommittee on Commerce and Finance probed the future structure of the securities market. J. Robert Doyle, now deceased, appeared on behalf of the Association. Mr. Doyle was President of Doyle, O'Connor & Company, Inc., of Chicago; Vice Chairman of the NASD Board; and Chairman of the Association's NASDAQ Committee. He emphasized the role the NASD, and especially NASDAQ, should play in any central market system, pointing out the special value to investors of the competition inherent in the NASDAQ system.

The Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs held several rounds of hearings in 1972. In May, David H. Morgan, President of the National Clearing Corporation, testified in support of proposed legislation to establish a uniform non-discriminatory nationwide system for comparison, clearing and settlement of securities. Mr. Morgan pointed out how NCC, as designed, fits the pattern of a nationwide clearing system outlined in the proposed bills. Despite much support in both the House and Senate, these bills died with the end of the 92nd Congress.

NASD President Gordon S. Macklin testified twice before the Senate Subcommittee—in early August and early October. In his August appearance he discussed the rule-making procedures of the NASD with special emphasis on the decision to include exchange listed stocks in NASDAQ. Other self-regulatory bodies informed the Subcommittee of their rule-making procedures as they pertained to specific cases.

In October President Macklin discussed the role of self-regulatory organizations. He criticized current duplicate regulatory efforts and encouraged greater cooperation between the regulatory agencies. Responding to questions of the Subcommittee, Mr. Macklin discussed the composition of the NASD Board of Governors, which now includes 2 representatives from outside the securities industry; the Association's rule-making procedures; the relationship of the NASD and the SEC; and progress with NASDAQ and the National Clearing Corporation.

In addition to acting as liaison between the Association and the Congress and government agencies, the Legal and Government Relations staff provides backup in legal matters in Association activities, including: rule-making, disciplinary procedings, and the NASDAQ-OTC Education Program.

NATIONAL CLEARING CORPORATION

The National Clearing Corporation, an NASD subsidiary created to develop and implement a nationwide continuous net clearing system for the OTC market, has grown in one year from a pilot project of eleven New York firms to a network of almost 300 firms in New York City, Boston, Philadelphia, and Chicago. By the end of 1972, NCC was clearing approximately 16,000 trades daily representing nearly $75 million in securities. National totals of OTC transactions are estimated to run as high as 40 to 50,000 trades daily.

In New York all phases of the clearing operations are handled by the National Clearing Corporation. While NCC's continuous net settlement system is used for clearing operations in Boston, Philadelphia, and Chicago, personnel and facilities are provided by the Boston, Philadelphia-Baltimore Washington, and Midwest Stock Exchange Clearing Corporations, respectively.

NCC chose the continuous net settlement method of clearing securities transactions as the most efficient and economical system for the OTC market. Main features of the system are: (1) all settlement, receipts, and deliveries of securities are made directly with an NCC clearing center, rather than between clearing members; (2) members are sent a daily statement indicating money and securities either owed to the NCC or credited to the firm; (3) NCC provides dividend accounting and processing of transfer instructions; and (4) all open securities positions are marked to the market daily. Continuous net settlement enables a broker to reduce delivery activity by about 65 per cent.

The Board of Governors has integrated the functions of the Uniform Practice Committee into the National Clearing Corporation with NCC now performing Uniform Practice rule-making functions. The NCC Board has formed a new committee to deal with Uniform Practice Matters.

Work is currently underway to develop a safekeeping capability for NCC, which will enable all broker/dealer members to deposit OTC securities with the clearing corporation in much the same way an individual deposits cash in a checking account. Settlement activity between members would then take place simply by debiting or crediting an appropriate account for the OTC trade, eliminating the need to physically deliver or receive stock certificates in most cases. It is planned to extend this capability to include deliveries among all NCC members and Central Certificate Service (CCS) members. Startup of the safekeeping system operation in New York is scheduled for mid-1973.

NCC's data processing equipment used to process orders under the continuous net system.

Future plans also call for the continued expansion of NCC operations to a number of key cities throughout the country. NCC's goal for the end of 1973 is to have the capability to clear 90 % to 95 % of all OTC transactions in the country. Ultimately, NCC will provide to all NASD members access to its nationwide clearing system.

Membership on the NCC's 17-man Board of Directors includes 15 industry representatives from California to New York reflecting the geographical dispersion of the OTC market. There are representatives from small regional firms as well as large New York based firms. The areas of expertise of the Board members include trading, operations, underwriting, general securities business, and bonds.

* * *

"The past is prologue." The events of the past year shine some light on what the future holds for the over-the-counter market. The success and acceptance of NASDAQ and the National Clearing Corporation's continuous net settlement system indicate that the OTC securities industry can benefit from further automation. Therefore, the Association's plans for 1973 include a hook-up between NASDAQ and NCC to implement a batch-type automated trade reporting network, resulting in first-time availability of individual trade information on OTC issues for clearance purposes.

The Association's chief goal for 1973, however, is to attain a more efficient and effective regulatory effort. The 1972 reorganization of the Association staff was a step in this direction. In 1973, we plan to further coordinate the Assocation's several regulatory arms and integrate regulatory information now becoming available through the National Clearing Corporation. More efficient operations will augment the Association's total regulatory capability to the benefit of the public and the Assocation membership.