Stock Ahead

Sometimes an investor who has entered an order to buy or sell a stock at a certain price will see transactions at that price reported on the ticker tape while his own order has not been executed. The reason is that other buy and sell orders at the same price came in to the specialist ahead of his and had priority. (See: *Book, Specialist*)

Stock Clearing Corporation

A subsidiary of the New York Stock Exchange, Inc. which acts as a central agency for clearing firms in providing a "clearance operation" through which transactions made on the floor are confirmed and balanced and, also, a "settlement operation" which handles the physical delivery of securities and money payments. (See: *Central Certificate Service*)

Stock Dividend

A dividend paid in securities rather than cash. The dividend may be additional shares of the issuing company, or in shares of another company (usually a subsidiary) held by the company. (See: *Ex-Dividend, Split*)

Stockholder of Record

A stockholder whose name is registered on the books of the issuing corporation. (See: *Record Date, Ex-Dividend, Ex-Rights*)

Stop Limit Order

A stop limit order to buy becomes a limit order executable at the limit price, or at a better price, if obtainable, when a transaction in the security occurs at or above the stop price after the order is represented in the Trading Crowd. A stop limit order to sell becomes a limit order executable at the limit price or at a better price, if obtainable, when a transaction in the security occurs at or below the stop price after the order is reoresented in the Trading Crowd.

Stop Order

A stop order to buy becomes a market order when a transaction in the security occurs at or above the stop price after the order is represented in the Trading Crowd. A stop order to sell becomes a market order when a transaction in the security occurs at or below the stop price after the order is represented in the Trading Crowd. A stop order may be used in an effort to protect a paper profit, or to try to limit a possible loss to a certain amount. Since it becomes a market order when the stop price is reached, there is no certainty that it will be executed at that price. (See: *Limited Order, Market Order)*

Stopped Stock

A service performed—in most cases by the specialist—for an order given him by a commission broker. Let's say XYZ just sold at $50 a share. Broker A comes along with an order to buy 100 shares at the market. The lowest offer is $50.50. Broker A believes he can do better for his client than $50.50, perhaps might get the stock at $50.25. But he doesn't want to take a chance that he'll miss the market—that is, the next sale might be $50.50 and the following one even higher. So he asks the specialist if he will stop 100 at ½ ($50.50). The specialist agrees. The specialist guarantees Broker A he will get 100 shares at 50½ if the stock sells at that price. In the meantime, if the specialist or Broker A succeeds in executing the order at $50.25, the stop is called off. (See: *Specialist*)

Street

The New York financial community in the Wall Street area.

Street Name

Securities held in the name of a broker instead of his customer's name are said to be carried in a "street name." This occurs when the securities have been bought on margin or when the customer wishes the securities to be held by the broker.

Switch Order—Contingent Order

An order for the purchase (sale) of one stock and the sale (purchase) of another stock at a stipulated price difference.

Switching

Selling one security and buying another.

Syndicate

A group of investment bankers who together underwrite and distribute a new issue of securities or a large block of an outstanding issue. (See: *Investment Banker*)

Tax-Exempt Bond

(See: *Municipal Bond)*

Technical Position

A term applied to the various internal factors affecting the market; opposed to external forces such as earnings, dividends, political considerations and general economic conditions. Some internal factors considered in appraising the market's technical position include the size of the short interest, whether the market has had a sustained advance or decline without interruption, a sharp advance or decline on small volume and the amount of credit in use in the market. (See: *Overbought, Oversold)*

Thin Market

A market in which there are comparatively few bids to buy or offers to sell or both. The phrase may apply to a single security or to the entire stock market. In a thin

market, price fluctuations between transactions are usually larger than when the market is liquid. A thin market in a particular stock may reflect lack of interest in that issue or a limited supply of or demand for stock in the market. (See: *Bid and Asked, Liquidity, Offer*)

Ticker

The instrument which prints prices and volume of security transactions in cities and towns throughout the U.S. and Canada within minutes after each trade on the floor.

Time Order

An order which becomes a market or limited price order at a specified time.

Tips

Supposedly "inside" information on corporation affairs.

Trader

One who buys and sells for his own account for short-term profit. (See: *Investor, Speculator*)

Trading Floor (See: *Floor*)

Trading Post

One of 23 trading locations on the floor of the New York Stock Exchange at which stocks assigned to that location are bought and sold. About 75 stocks are traded at each post. (See: *Inactive Post*)

Transfer

This term may refer to two different operations. For one, the delivery of a stock certificate from the seller's broker to the buyer's broker and legal change of ownership, normally accomplished within a few days. For another, to record the change of ownership on the books of the corporation by the transfer agent. When the purchaser's name is recorded on the books of the company, dividends, notices of meetings, proxies, financial reports and all pertinent literature sent by the issuer to its securities holders are mailed direct to the new owner. (See: *Delivery, Registrar, Street Name*)

Transfer Agent

A transfer agent keeps a record of the name of each registered shareowner, his or her address, the number of shares owned, and sees that certificates presented to his office for transfer are properly cancelled and new certificates issued in the name of the transferee. (See: *Delivery, Registrar, Transfer*)

Transfer Tax

A tax imposed by New York State when a security is sold or transferred from one person to another. The tax is paid by the seller. On sales by New York State residents, it ranges from 1.25 cents a share to 5 cents a share sold for $20 or more. Sales by out-of-state residents not employed in New York are taxed at reduced rates. There is no tax on transfers of bonds.

Treasury Stock

Stock issued by a company but later reacquired. It may be held in the company's treasury indefinitely, reissued to the public, or retired. Treasury stock receives no dividends and has no vote while held by the company.

Turnover

The volume of business in a security of the entire market. If turnover on the NYSE is reported at 15 million shares on a particular day, 15,000,000 shares changed hands. Odd-lot turnover is tabulated separately and ordinarily is not included in reported volume.

Two-Dollar Broker

Members on the floor of the NYSE who execute orders for other brokers having more business at that time than they can handle themselves, or for firms who do not have their exchange member-partner on the floor. The term derives from the time when these independent brokers received $2 per hundred shares for executing such orders. The fee is paid by the broker and today it varies with the price of the stock. (See *Commission Broker)*

Underwriter (See: *Investment Banker*)

Unlisted

A security not listed on a stock exchange. (See: *Over-the-Counter*)

Unlisted Trading Privileges

On some exchanges a stock may be traded at the request of a member without any prior application by the company itself. The company has no agreement to conform with standards of the exchange. Today admission of a stock to unlisted trading privileges requires SEC approval of an application filed by the exchange. The information in the application must be made available by the exchange to the public. No unlisted stocks are traded on the New York Stock Exchange. (See: *Listed Stock*)

Up Tick

A term used to designate a transaction made at a price higher than the preceding transaction. Also called a "plus-tick." A stock may be sold short only on an up tick, or on a "zero-plus" tick. A "zero-plus" tick is a term used for a transaction at the same price as the preceding trade but higher than the preceding different price.

Conversely, a down tick, or "minus" tick, is a term used to designate a transaction made at a price lower than the preceding trade. A "zero-minus" tick is a transaction made at the same price as the preceding sale but lower than the preceding different price.

A plus sign, or a minus sign, is displayed throughout

the day next to the last price of each company's stock traded at each trading post on the floor of the New York Stock Exchange. (See: *Short Sale*)

Voting Right

The stockholder's right to vote his stock in the affairs of his company. Most common shares have one vote each. Preferred stock usually has the right to vote when preferred dividends are in default for a specified period. The right to vote may be delegated by the stockholder to another person. (See: *Cumulative Voting, Proxy*)

Warrant

A certificate giving the holder the right to purchase securities at a stipulated price within a specified time limit or perpetually. Sometimes a warrant is offered with securities as an inducement to buy. (See: *Rights*)

When Issued

A short form of "when, as and if issued." The term indicates a conditional transaction in a security authorized for issuance but not as yet actually issued. All "when issued" transactions are on an "if" basis, to be settled if and when the actual security is issued and the Exchange or National Association of Securities Dealers rules the transactions are to be settled.

Wire House

A member firm of an exchange maintaining a communications network linking either its own branch offices, offices of correspondent firms, or a combination of such offices.

Working Control

Theoretically ownership of 51 per cent of a company's voting stock is necessary to exercise control. In practice —and this is particularly true in the case of a large corporation—effective control sometimes can be exerted through ownership, individually or by a group acting in concert, of less than 50 per cent.

Yield

Also known as return. The dividends or interest paid by a company expressed as a percentage of the current price—or, if you own the security, of the price you originally paid. The return on a stock is figured by dividing the total of dividends paid in the preceding 12 months by the current market price—or, if you are the owner, the price you originally paid. A stock with a current market value of $40 a share which has paid $2 in dividends in the preceding 12 months is said to return 5 per cent ($2.00÷$40.00). If you paid $20 for the stock five years earlier, the stock would be returning you 10 per cent on your original investment. The current return on a bond is figured the same way. A 3 per cent $1,000 bond selling at $600 offers a return of 5 per cent ($30÷$600). Figuring the yield of a bond to maturity calls for a bond yield table. (See: *Dividend, Interest*)

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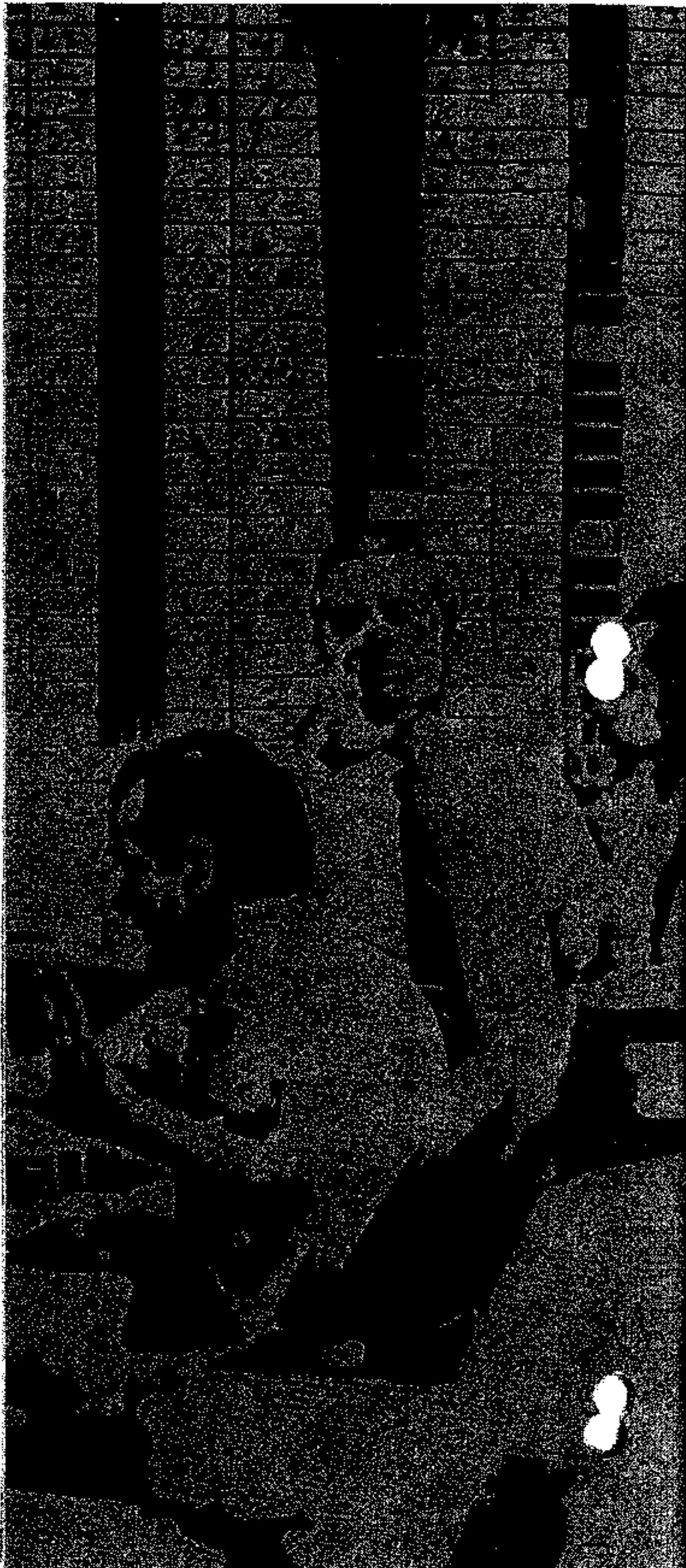
NASDAQ & THE OTC

How the NASDAQ system creates an Electronic Stock Market in Over-The-Counter securities

On February 8, 1971, the over-the-counter securities market stepped quietly and successfully into the computerized world of the future by acquiring an electronic central nervous system with the somewhat strange name of NASDAQ (pronounced NAZ-DAK). NASDAQ is an acronym for the National Association of Securities Dealers Automated Quotations.

To the casual observer, this important milestone for the securities industry and investing public may have gone unnoticed since it did not markedly change the format or content of the over-the-counter stock tables displayed on the financial pages of many newspapers across the country. While the general appearance of these OTC tables may have been almost the same, shortly after start-up closer examination would have shown that the spread between bid and asked quotations had narrowed considerably for many of the stocks listed there, and that an additional column with volume information had been included.

At securities firms, too, outward appearance might have been deceptive, since customers' requests for quotations and their buy and sell orders in OTC stocks were handled in essentially the same manner as in the past. Except that now the elapsed time for a transaction to take place, from quotation to order confirmation, had been reduced dramatically and the reliability of current quotations given by



firms or closing quotes published in newspapers had been vastly improved.

Despite these unobtrusive aspects, the advent of NASDAQ has been rightly characterized as a major revolution in the securities industry which will significantly improve the quality and dependability of information available to investors—both institutional and individual—and for broker/dealer firms in this large and important segment of the securities markets.

And yet before one can understand NASDAQ's present impact and future promise, one must understand the over-the-counter market itself; what it is, how it functions, and the extent and scope of its position in the fabric of the overall financial community. This booklet describes these relationships and shows how NASDAQ is changing the visibility and available knowledge of the OTC market for the benefit of all types of investors.

What is the over-the-counter securities market?

Simply stated, the over-the-counter market is all of the buying and selling activity in securities that does not take place on a stock exchange. While the OTC market includes from 30,000 to 40,000 common stocks of public corporations, only about 10,000 to 12,000 issues trade with any regularity within a given year and only 5,000 of these could be described as actively traded.

Most corporate bonds are traded in the OTC market as

well as state, municipal and U.S. government obligations. All new issues of any security offered to the public for the first time are traded in the OTC market and secondary distributions of large blocks of stock, whether exchange listed or not, usually are offered to the public at a fixed price in the OTC market. Since open-end investment company shares (mutual funds) are considered new issues under law, these are also sold within the over-the-counter market structure. Most banks and insurance company stocks trade in the OTC market, as do many Canadian and other foreign issues including American Depository Receipts.

Almost every conceivable size and type of company, product or service is represented in the over-the-counter market. Issues of public utilities, chemical companies, petroleum pipe lines, transportation companies, textile manufacturers, breweries, retailers, manufacturers, and raw material producers have the stock of their corporations merchandised and traded by a national network of some 4,400 broker/dealers in the over-the-counter market.

Each year, an increasing number of companies must seek capital from the general public to develop new products and explore new markets. This capital is obtained in exchange for the privilege of a share in ownership offered by the company's stock. The burgeoning demand for capital serves to broaden the number of stocks in the over-the-counter market,

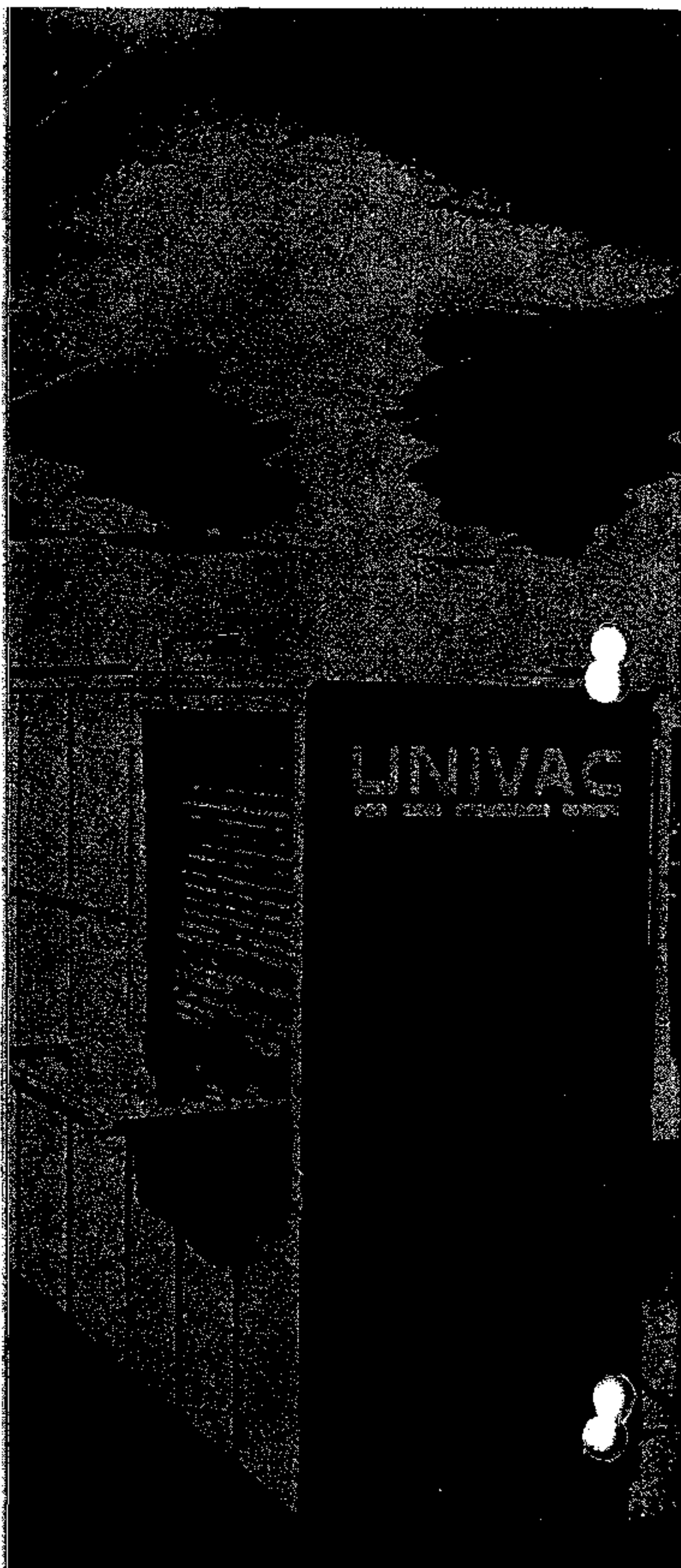
which in turn provides a wider range and greater number of opportunities for investors.

Because of this ever growing need for new capital, the over-the-counter market is a key factor in economic expansion. Without this market, American industry could well be starved for new capital, while investors would have far fewer choices as to where to invest their money. It is a matter of record that many shareowners acquire their first securities by buying OTC stocks, often the issues of companies for which they work, or industries and local businesses in their own home towns.

Some investors and casual followers of the financial pages assume that if a security isn't listed on a stock exchange then the stock is one of inferior quality. This is certainly far from the truth. The over-the-counter market offers investors a broad variety of issues ranging from little known, unproven speculative stocks to some of the gilt-edged giants of the American industry.

Many investors, analysts and institutional managers interested in growth are constantly searching the over-the-counter market to find those special situation companies which show unusual potential for future expansion. Many of the glamour stocks of today grew up in the over-the-counter market, which has been called the spawning ground for the IBM's and Xerox's of the future.

A recent study conducted by the trade publication "Over-the-Counter Securities Review"



indicates that in terms of common stocks alone the over-the-counter market had a minimum value of 150 billion dollars as of the end of December, 1971. The same publication also reported that there were six OTC companies whose stocks had a market value exceeding $1 billion each (the top company's stock was valued at $2.2 billion). There were about 20 companies with a market value of better than $500 million each and almost 200 with a market value of over $100 million each.

The OTC market—how does it operate?

The over-the-counter market is essentially a way of doing business by *negotiation*, in contrast to a stock exchange, which is a central market place or location housing facilities for trading securities by an *auction* system. OTC securities are generally bought and sold through a network of thousands of dealers in large and small cities across the country linked together previously by only the telephone and telegraph. Now the NASDAQ quotations system has tied this 3,000-mile long trading floor into a single visible marketplace. Professional buyers and sellers seek each other out with the touch of a button and negotiate prices on the most favorable basis that can be achieved. Often these negotiations are accomplished in a matter of seconds. Because over-the-counter securities are traded by a widely dispersed negotiated

system rather than in an auction market with a fixed location, in the past there was no method of disseminating information on a current basis. However, the new NASDAQ quotations system has provided the binding link through which investors in all parts of the country can instantly have at their finger tips current representative bid and asked quotations and broker/dealers can have up-to-the-second quoted prices of all market makers in the NASDAQ system. Firms that maintain markets and inventories in OTC stocks continuously update and adjust their quotations throughout the day on the issues in which they hold an interest and NASDAQ instantaneously distributes this information to all firms that subscribe to the service.

On the other hand, exchange trading is conducted in the manner of a two-sided auction so that when a buy and sell order coincide as to price they are matched and a transaction takes place. On exchanges all orders to buy or sell any of the securities listed there are funneled on to the exchange floor from offices of member firms. Brokers with orders to buy a given stock meet brokers with orders to sell at what is called a trading post where all transactions in that stock take place. The price of the last transaction is posted there, and the specialist or market maker who is responsible for that particular security will post the highest bid and lowest offering price

prevailing at that time as his market quotation. Buying and selling brokers can then enter their own bids and offers and when these prices meet, a transaction takes place, and it is put on a ticker which announces the name of the stock, the number of shares traded and the price.

The complexion of the exchange markets today has been changed materially by the emergence of institutional purchases and sales in large blocks so that the generalized concept of an auction market is no longer completely accurate. Large block trades which are crossed on the floor of a stock exchange usually have been negotiated first as to price by the broker or brokers representing two or more institutional investors and displayed on the exchange tape for record purposes. In addition, in an auction situation when there is an imbalance in supply and demand, i.e., more buy orders than sell orders or vice versa, then the specialist in that stock must assume the position of a dealer and handle the trade from his own inventory in much the same manner as an over-the-counter dealer.

A pivotal figure in the OTC distribution system is the dealer who continuously maintains a market in certain issues and stands ready to buy and sell much in the same manner as a wholesale supplier of any goods or merchandise. Thus, a market maker plays a role similar in many ways to that of a specialist on a stock exchange; with an

important difference. In most exchange stocks, only one specialist makes a market; but there are often five or more competing market making dealers bidding and offering a particular over-the-counter security. Through his activities in buying and selling for his own account with other market makers, and the execution of trades for retail firms with customer orders, the market maker provides depth and liquidity in the issues traded as well as a stabilizing force during temporary imbalances in the market.

The vital role of the OTC trader.

When you place an order to buy or sell an over-the-counter stock, the stockbroker with whom you deal transmits your order to the OTC order room of his firm. Here, an OTC order trader assumes the responsibility for completing the transaction at the best price he can, taking into account the size of the order and the ability of a particular market maker to handle the size in question.

He does this by determining the dealer making the best market and then arriving at an equitable price through negotiation. The trader's job is a demanding one, and his high competence and knowledge contributes greatly to the smooth functioning of the over-the-counter market. To foster higher standards in these areas, most securities traders belong to the National Securities Traders Association, a professional organization with more than

5,000 members and 32 affiliates nationwide.

Important Note: The fact that a firm does business as an OTC dealer or broker does not prevent it from being an exchange member. Most stock exchange member firms maintain OTC departments. Many individual firms make markets in hundreds of OTC securities.

The OTC market: Advantages for corporations and investors.

Many companies that could list on a national or regional exchange choose to remain in the OTC market because of this highly efficient network of multiple, competing dealers that must be responsive to present and potential shareholder needs.

By far, the most important advantage of the OTC market is this multiple dealer support, merchandising and sponsorship. Prior to the development of a broad and spontaneous market for a particular stock, a company is dependent upon over-the-counter dealers for the maintenance of a market and stimulating of investor interest. In this highly competitive atmosphere, the activities of dealers are determined both by investment attraction of the stock and profitability of trading the issue.

This responsibility to provide the best possible market for a stock is neither casual nor theoretical, since the OTC market maker will generally have substantial capital

committed in maintaining his inventory. In most cases the combined capital from a dozen or more market makers competing in the same OTC security, far exceeds the capital resources of the single exchange specialist trading in a similar listed security. Such market making activity has a beneficial effect on supply and demand because of the interaction between competing dealers which complements their merchandising activities and contact with investors.

Indeed, it is dealer competition in market making that acts as a balance wheel for the OTC securities market. Even though dealers are not physically together, they are in constant communication so that price spreads seldom drift far apart. The NASDAQ communications system which now ties together almost all retail firms and OTC market makers has added the missing link to this competitive structure by providing instant trader access to up-to-the-minute quotations of all market makers in a particular stock, regardless of their physical location. If a dealer should become out of line on his quotes, other competing dealers find it profitable to sell to him or buy from him until he adjusts his quotations. Thus inter-dealer trading, coupled with the visibility of NASDAQ, is an important factor in maintaining a closely competitive market with narrow spreads between bids and offers.

Just as it is true that some

companies in the OTC market may be suited and ready for exchange listing, it is also a fact that a great number of other companies are not. A premature move to an exchange can have serious, adverse effects on the market for a stock, effects which are compounded by the fact that listing is virtually an irrevocable decision.

The major problem for an OTC company is not really a "to list or not to list" dilemma. Rather, it is to decide *when*, if ever, listing would be advantageous.

The amount of spontaneous investor interest is an important yardstick for company officials to consider in making the listing decision. When the stock of a company can trade more or less by itself without the merchandising efforts of OTC market makers and retail dealers, then that company may be ready to consider exchange listing. It is vital to remember however, that many companies may never achieve this status where they command instant investor recognition and interest.

Furthermore, exchange listing which eliminates the dealer market will definitely result in a loss of interest by non-members of the exchange and possibly even a reduction of interest by dealers who are exchange members, since trading in exchange listed securities generally does not encourage the retail merchandising efforts commonly associated with over-the-counter stocks which have growth potential.

The OTC market—
How it is supervised.

From a daily operational standpoint, the National Association of Securities Dealers, a non-profit, self-regulatory agency based in Washington, D. C., is the most important body regulating and policing the OTC market. Over 4,300 brokers and dealers including almost all members of stock exchanges, belong to this organization and agree to abide by its rules as a condition of membership.

The NASD came into being in the 1930's as a result of Federal government legislation. It is registered with and works in close conjunction with the Securities and Exchange Commission, the Federal agency charged with overseeing all of the stock exchanges and any such national securities associations.

Governed by an elected 25-man Board of Governors from the securities industry and supplemented by hundreds of working committeemen from all sections of the country, the NASD has the power to enforce with its members just and equitable principles of trade, and to censure, fine, suspend or expel members who violate its rules. As the principal watchdog of the OTC market, the NASD periodically inspects the books and records of each member firm on a surprise basis to be sure that the Association's many rules are being properly observed and to determine the capital condition of the firm.

For example, the NASD, which is financially supported

by its members, rather than with taxpayers' money, requires thorough training and the successful completion of qualifying examinations for all principal officers and salesmen of broker/dealer firms. The NASD, through its 475 employees, also maintains close surveillance over misleading advertising, excessive mark-ups or commissions and requires member firms to properly supervise all activities of registered representatives.

The NASD is also presently establishing a market surveillance program through its new NASDAQ system which will help discover possible fraudulent or manipulative practices in the OTC market.

ENTER NASDAQ

Ever since the early 1950's, volume of securities trading has been climbing steadily in all markets, both listed and over-the-counter.

While the financial community could cope with this increasing business up to a point by adding personnel and equipment, areas of critical pressure began to appear. By the mid-1960's, it had become evident that what had been instituted as solutions were at best stop-gap measures, ineffective in the face of volume

that was exceeding the most optimistic projections by a substantial margin.

The over-the-counter market faced a special problem. The normal system for obtaining quotations in this market called for a broker to check with several dealers by telephone in order to develop reasonably accurate bid and asked figures. Even then the broker could not be absolutely sure that he had obtained the best possible price for his customer except in those cases where all market making dealers were checked. This was not practical for those stocks in which five or more dealers in different locations maintained regular markets.

As volume reached record heights, the system which had worked well for many years reached its limits. It was becoming saturated with more trading activity and more demand for quotes than it could handle effectively. Stockbrokers were having difficulty securing bid and asked prices for their clients. And the clients were becoming disenchanted with the slowing service.

The National Association of Securities Dealers set out to correct the situation. Although the complexity of the OTC market presented several major difficulties, a comprehensive analysis showed both the need for and the feasibility of designing and implementing an automated quote system that would preserve and enhance the negotiated character of the OTC market which had served the needs of individual investors

for many years. After much careful study and many discussions with leaders in the financial community, the NASD signed a contract with the Bunker Ramo Corporation to build a $25 million electronic communications system to tie the OTC segment of the industry together into one vast electronic stock market. NASDAQ, the NASD's automated quotation system, is the result of these efforts. The system became a reality on February 8, 1971 at 10:00 a.m.

NASDAQ:
What it is.

NASDAQ is a computerized communications system that collects and stores up-to-the-second quotations from a nationwide network of OTC dealers making markets in stocks which have been approved for inclusion in the NASDAQ system. On December 31, 1971, there were 3,000 companies listed on NASDAQ; companies which are required by the NASD to have $1 million in assets, 500 or more shareholders, a minimum of 100,000 shares outstanding and at least two broker/dealers registered as market makers and continually quoting the stock in the system. NASDAQ companies must also meet the same SEC reporting and disclosure standards as established for exchange listed stocks.

The heart of the system is located in Trumbull, Connecticut where a staff of programmers and technicians man the central

computer complex. Smaller supplemental computers are also located in several cities throughout the country. The data center at Trumbull contains back-up equipment of every vital element to insure continuous service. If public power fails, a giant bank of storage batteries supplies power until a turbo-generator system comes on line. Temperature and humidity are rigidly controlled. All stock data is recorded in duplicate and there are strict security systems to keep information and equipment protected.

The 3,000 stocks on NASDAQ number about as many as those listed on the New York and American Stock Exchanges combined. Most of the stocks now in the system are OTC stocks but a number of securities listed on major exchanges are also carried. Listed stocks handled by non-exchange market-making OTC dealers and traded off the floors of the exchanges are the stocks which comprise the so-called "Third Market."

NASDAQ:
How it works.

To make sound decisions, investors, OTC traders, and market-making dealers need information. Accurate, immediate information. NASDAQ gives it to them. And since the information needs of each of these three groups is somewhat different, NASDAQ provides information in three separate formats (or levels) that are specially tailored to the requirements of each.

LEVEL 1

As the system is organized, Level I service is designed to serve individual investors who are clients of the retail branches of brokerage firms. It takes the quotations of *all* dealers making a market in a stock and delivers current representative bid and asked prices. This is actually a median quote representing the middle point of the quotes of all the dealers. Since any NASDAQ stock has a minimum of two market make and some as many as twenty-fi or thirty, this quotation will fairly reflect the existing market.

The representative quote is transmitted electronically from the computer center and is received on about 20,000 standard desk top quotation units that are familiar pieces of equipment in most brokerage firm offices.

What is of key importance with Level I service is the fact that quotations are current, accurate, and visible. All market makers in a particular stock are obligated to feed changes in bid or asked prices into the system immediately. These changes appear on terminals within five seconds.

Thus, with stocks in the NASDAQ system, you can call your broker for a quote, receive it immediately, make your decision to buy or sell then and there, while you are still on the telephone. Further, you can be confident that the quotation is accurate, and that the price you pay or receive will be at or very near the quoted bid or offer.

LEVEL 2

Boon to retail traders and large-scale order executers.

Level II terminals are specially designed units with TV-type screens to serve the needs of two kinds of users:
1. Broker/dealers retailing OTC securities to the public.
2. Large-scale professional order executers. By pressing a few buttons on the keyboard of the Level II unit, the trader can see immediately all the current quotations of the market makers in a specific stock in the NASDAQ system. The quotes of only five market makers, ranked according to the best prevailing bids or offers at that time, are displayed on the screen. If there are more, the balance can be retrieved in groups of five by pressing a special "more" button.

NASDAQ eliminates literally thousands of telephone calls that were formerly made in an effort to determine which dealer was making the best market. The system also enables brokerage firms and institutional investors to gain prompt execution of orders since the trader can directly contact the dealer showing the best

market to complete the transaction.

NASDAQ does not change the actual trading process. Once he knows what the quotations are, the trader must still telephone or activate a direct wire to the market maker. As an investor, you still have the skill of a retail trader working for you but, thanks to NASDAQ, the procedure is considerably quicker. It's easy to see why. Prior to NASDAQ, the majority of calls were to secure quotations. Today, 90% of the calls a market maker receives from brokers are for the purpose of consummating a trade, according to the head of a large trading firm in New York City.

Helping market makers make markets.

Some 600 market making dealers are equipped with Level III units that are similar to Level II equipment except that they have added features which enable the dealer to enter and change or update quotations on the stocks in which he makes markets. Entries and changes are fed into the computer system and within five seconds the current figures will appear on all Level II and III terminals everywhere in the country. In addition, the representative

bid & asked price showing on Level I units will also be automatically adjusted.

Dealers cannot make markets in any stocks without prior authorization from the NASD. Dealers must meet and maintain certain capital standards and they must agree to make markets on a regular basis. Only when he has been approved as a market maker can a dealer enter quotations and changes into the NASDAQ system, and then only for those stocks in which he has authority to act as a market maker. It is physically impossible for him to enter or change the quotes of any stocks but his own.

In accordance with NASD rules, market-making dealers are required to execute transactions for at least 100 shares of stock upon the request of other NASD members at the dealers' prevailing quotations in the NASDAQ system.

Buying or selling stock in the *OTC market* with NASDAQ.

Perhaps the simplest way to understand how the OTC market and NASDAQ works is to trace the step-by-step route of an order to buy the stock of XYZ Company whose shares trade in the OTC market and are quoted on NASDAQ.

Assume that your stockbroker has recommended XYZ to you as having above average growth potential. It is a young company and he advises that he is sending you a report recently published by the research department of his firm.

When the report arrives, you check out the figures and agree that the possibilities for XYZ are good. You decide to buy 200 shares if you can purchase them for around 20, the approximate market price indicated in the research report.

You discuss your thinking with your broker and ask him for a current quotation. After checking his desk-top NASDAQ quotations unit, he tells you that the current representative market is 20¼ bid, 21 offered. This means that under normal market conditions you should be able to buy your stock at $21 a share or slightly less, plus the broker's commission.

Prior to NASDAQ, your broker might have taken the quotation from the National Quotations Bureau "pink sheets." This quote might have been out of date by several days. If it came from the newspaper stock tables, it would have been obtained by the NASD from just one market maker and it would have been at least 24 hours old.

Before NASDAQ, to obtain a current quote, your broker would have asked his order clerk to check the market, a procedure requiring telephoning at least three market makers. Delays of a half hour or more were common during busy periods, and the spread between bid and asked quotes was apt to be quite wide—as much as a point or even two on stocks in the 20 to 30 dollar a share price range. Now with NASDAQ, investors can have an accurate quote immediately, and because each dealer can see his competitor's quotations, spreads tend to be much narrower.

You decide to proceed with the purchase and instruct your broker to buy the two hundred shares "at the market." He in turn writes up your order and transmits it to his OTC order room. Up until the moment of transmission, the procedure is exactly the same as if you were buying a stock on the New York or any other registered stock exchange.

Here, the steps become slightly different as the traders in your stockbroker's OTC order room go to work. Since XYZ is in the NASDAQ system, the trader would check his NASDAQ unit's TV screen and go right to the dealer displaying the best market. The trader would then consummate the order with the appropriate market making dealer.

When the transaction had been completed and your 200 shares of XYZ purchased (probably within seconds), your broker's trader would then report back the successful execution, including the price at which he had bought the stock. Your broker would then call you, just as he would in the case of any listed stock.

Again, prior to NASDAQ, another difficulty often surfaced at this point that caused many investors to be uneasy about the OTC market. This difficulty —directly traceable to reliance on outdated quotes—was the frequently wide variation between

quoted prices in newspapers and actual execution prices. For example, on a quotation of 20¼ bid, 21 offered, an investor would logically assume that he would pay 21 or less, plus commission. On too many occasions in the pre-NASDAQ era, however, the cheapest stock available might turn out to be 21½, 22, or more—not because of any unethical practice on the part of dealers or because of extremely volatile market conditions, but because of the slow, outmoded quotation system that could not give current prices.

NASDAQ: What it means for both corporations and investors.

NASDAQ brings visibility to the over-the-counter market. People know what's going on because they can see what's going on. This visibility factor along with speed and accuracy of quotations are important elements revolutionizing the OTC market.

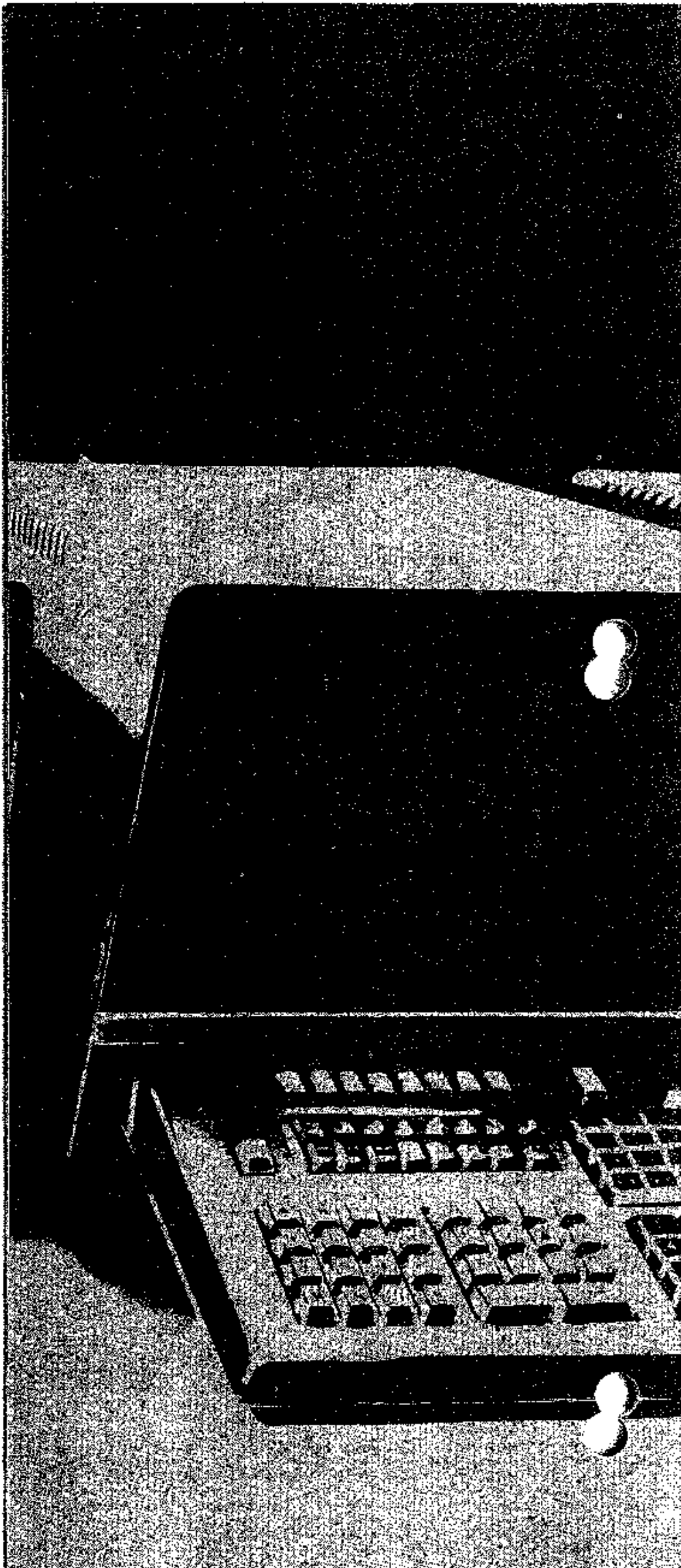
Several months after NASDAQ became operational, the NASD began compiling and releasing price indices on general segments of the OTC market. These indices, which include all domestic common stocks listed in the system, are divided into seven categories: Composite, Industrials, Banks, Insurance, Other Finance, Transportation, and Utilities. Together they provide, for the first time, a comprehensive and accurate gauge of OTC performance.

On December 31, 1971,

the Industrial Index was 116.53, up significantly from the base of 100 assigned when the system started in February of 1971. Also showing increases were Insurance at 121.33, Other Finance at 116.91, Transportation at 120.12, the Composite Index was recorded at 114.12, and Banks at 101.82. Utilities at 94.37 had dropped somewhat since February.

The NASDAQ OTC Price Indices are available over the NASDAQ terminal screens where they are updated every five minutes. They are also distributed three times a day through the wire services—at 11:00 a.m., 12:30 p.m. and at 3:30 p.m.

Live volume figures on OTC stock trading has always been an important investor tool missing from the arsenal of information needed by astute followers of the market. The most recent service provided by NASDAQ is the availability of volume statistics on OTC activity. Never before was there such a yardstick for measuring activity in the over-the-counter market. The release of volume information has brought to light some interesting and, perhaps, unsuspected data on the magnitude of NASDAQ activity as compared to the exchanges. It has shown that daily volume of shares traded over-the-counter on NASDAQ is greater than the total volume on all other exchanges combined with the exception of the New York Stock Exchange. NASDAQ volume consistently runs about



half the Big Board's volume. During the week of November 1 through 5, the first week volume information was released, NASDAQ volume was reported as 33,309,300 shares traded, double the American Stock Exchange volume which was reported at 16,560,000. During the same week 65,410,000 shares changed hands on the New York Stock Exchange.

NASDAQ trading amounted to 138,129,900 shares during November, for an average of 6,577,624 shares traded daily; and expanded during December to 188,247,200 shares, averaging 8,556,691 shares traded daily. It has been projected, based on the aggregate NASDAQ volume reported for November and December 1971, that more than two billion shares could be traded on the NASDAQ system in 1972.

NASDAQ volume information, which is released directly from the NASDAQ central computers to the wire services every day, includes volume figures for each NASDAQ security, total volume of all NASDAQ common and preferred stocks, and a list of the ten most actively traded NASDAQ stocks. The system also transmits to wire services, weekly, monthly and yearly market summaries, providing a base for more comprehensive analysis of OTC activity. With daily volume figures on each NASDAQ stock transmitted to the wire services every trading day, investors and corporate executives are now able to measure the depth and liquidity

of the market in any particular stock. They can gauge the momentum of trends and check to see price movements on heavy or light volume. Volume figures supply a whole new dimension to the OTC market.

Another benefit of this automated system is that NASDAQ has shown at least two and sometimes as many as 20 or 30 dealers make markets in any NASDAQ stock. As we have seen, the structure of multiple market makers provides companies "listed" on NASDAQ with strong dealer support, merchandising and sponsorship for the securities carried in the system. The multi-dealer structure combined with visible quotations also introduces an element of intense competition. A recent magazine article cites instances where stocks in the $80 a share range were quoted on NASDAQ with spreads of only half a point between bid and asked.

The next steps: Nationwide automated clearing of transactions and the reporting of actual trades.

When the NASD began developing NASDAQ, it also began to plan for a companion automated system which would clear and settle OTC transactions on a nationwide basis.

Currently, most brokers in the OTC market settle their trades directly with other firms. Documents are mailed or sent by messenger to these other firms—a cumbersome, time-

consuming process that functions inefficiently in times of high volume and often causes investors problems in delays in obtaining stock certificates purchased.

Now, the National Clearing Corporation—a wholly owned subsidiary established by the NASD—has developed an automated system that will compare, clear and settle OTC trades on what is termed a continuous net basis. Under this system, all settlements will be made directly with the clearing corporation rather than between individual brokers. The system already being operated on a pilot basis in New York City, is expected to include all OTC firms in the New York area by mid-1972 and become operational nationally by 1973.

This system is expected to reduce costs, reduce lost and stolen securities, and eliminate most errors and delays by minimizing internal accounting and paperwork processing. It has been estimated that 60% of all current deliveries will no longer be necessary and that trades that do not match could be cut almost in half.

NASDAQ's remarkable success as a communications system has prompted interest in developing a new and wider role for the system in the OTC market. Work is already underway on the development of a process whereby market makers will be able to report actual trades into the system. It is anticipated that this information will become part

of the over-the-counter clearing operations of the National Clearing Corporation.

NASDAQ: Where does it go from here?

A good question since the possibilities open to the NASDAQ system are many and varied. For example, direct voice communication between retail traders and market makers over the NASDAQ system is entirely feasible. There is also the potential for the compilation of vast amounts of statistical data on OTC trading that would be of immense benefit to research departments and technical market analysts.

Another potential of the NASDAQ system is to aid the NASD in regulation of the over-the-counter market. Serving as a window on OTC activity, the system enables the Association to observe what's happening and where. Now underway, on a pilot basis, is a Stock Watch-Market Surveillance Program. Like similar programs at various Exchanges, it notes wide price and volume fluctuations and examines the reasons for these fluctuations.

It is an undeniable fact that NASDAQ has created a ferment in the world of finance. The electronic stock market is truly a revolutionary advance. And like all revolutions, no one knows for sure quite where or how it will all end. But whatever the end, you may be certain of one thing: Investors are benefiting.

For RELEASE Monday, September 13, 1971

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

SECURITIES EXCHANGE ACT OF 1934
Release No. 9310

ADOPTION OF RULE 15c2-11 UNDER THE SECURITIES EXCHANGE ACT OF 1934

The Securities and Exchange Commission today announced the adoption of Rule 15c2-11 under the Securities Exchange Act of 1934 ("the Act"). In general, Rule 15c2-11 prohibits the initiation or resumption of quotations respecting a security by a broker or dealer who lacks specified information concerning the security and the issuer.

On June 24, 1970, in Securities Exchange Act Release No. 8909, the Commission published its proposal to adopt Rule 15c2-11. It has considered the comments and suggestions it received in response to that proposal and now adopts the rule in the form set forth below.

The Commission has discussed on an earlier occasion the practices of some companies and persons in connection with the distribution of the securities of "shell" corporations by means of the "spin off" device. 1/ These practices have often resulted in the initiation of market making activities by some brokers and dealers by the submission of quotations, in most cases, at a time when no financial or other information concerning the security or the issuer was available to either the brokers and dealers submitting the quotations or to public investors induced to purchase the security. Frequently, there was a substantial increase in the market price of the securities due, in large measure, to the fraudulent and manipulative activities of the persons involved.

Although the practices discussed in Securities Act Release No. 4982 involved the securities of "shell" corporations, the fraudulent and manipulative potential inherent in those situations also exists when a broker or dealer submits quotations concerning any infrequently-traded security in the absence of certain information.

Therefore, to protect public investors against these occurrences, Rule 15c2-11 (subject to certain exemptions) prohibits a broker or dealer from submitting any quotation (as defined) for any security to any quotation medium unless (a) a registration statement has become effective

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1/ Securities Act Release No. 4982, July 2, 1969.

with respect to such security within 90 days prior to the time of submission or publication of the quotation, and was not subject to a stop order at the time of such submission or publication, and unless the broker or dealer has in his records a copy of the prospectus, or (b) a notification under Regulation A has become effective with respect to such security within 40 days prior to the time of submission or publication of the quotation, and was not the subject of a suspension order at the time of such submission or publication, and unless the broker or dealer has in his records a copy of the offering circular, or (c) the issuer is required to file reports pursuant to Section 13 or 15(d) of the Act, or is the issuer of a security covered by Section 12(g)(2)(B) or (G) of the Act, the broker or dealer has a reasonable basis for believing that the issuer is current in filing the reports or statements required, and the broker or dealer has in his records a copy of the issuer's most recent annual report and any other reports required to be filed at regular intervals which were filed after such annual report, or (d) the broker or dealer has in his records specified information, which he must make reasonably available to any person expressing an interest in entering into a transaction in that security with him, and which he has no reasonable basis for believing is not true and correct, and which was obtained by him from sources which he has a reasonable basis for believing are reliable. As that term is used in the rule, the requirement that the broker or dealer "make reasonably available" the specified information would mean that the broker or dealer must furnish the information to the interested person at the cost of reproduction, if for any reason it is impractical to provide the information in any other manner. The rule also requires the broker or dealer to send to the inter-dealer-quotation-system, at least 2 days before the submission or publication of the quotation, the specified information in a form prescribed by such system.

The rule also requires that the broker or dealer keep, with respect to any quotation which is within the provisions of the rule, records regarding all the circumstances surrounding the quotation, including the identity of the persons for whom the quotation is submitted or published and any information given the broker or dealer by such persons. All information required to be kept by the broker or dealer is to be maintained and preserved as part of his records for the periods specified in Rule 17a-4 of the Act.

The rule exempts from its provisions the submission or publication of a quotation respecting a security admitted to trading on a national securities exchange which is traded on such an exchange on the same day or on the day before the day of submission or publication. The rule also exempts a security which has been the subject of both bid and ask quotations at specific prices at least twelve days within the previous thirty calendar days with no more than four business days in succession without such a quotation. 2/ Some of the comments received requested the Commission

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2/ It should be noted that this exemption provision requires prior quotations at the specified frequency for the period immediately preceding the broker's or dealer's submission or publication of his quotation. Thus, the exemption does not apply if at any time the market for the security in the previous thirty days has not met the specified conditions.

to exempt from the provisions of the rule certain situations which, it was claimed, are not within the basic purpose of the rule. There is a general provision exempting the publication or submission of any quotation which the Commission may exempt, either unconditionally or upon specified terms and conditions, as not constituting a fraudulent, manipulative or deceptive practice comprehended within the purpose of the rule. Those persons who believe that the submission or publication of their quotations would not contravene the purpose of this rule are invited to make a written submission stating their reasons and specific facts supporting that belief, in order to afford the Commission an opportunity to determine whether to apply this exemptive provision in those situations.

It should be emphasized that this rule is not intended to, and does not, excuse brokers and dealers from their duty to comply with applicable registration and other anti-fraud provisions of the federal securities laws and Commission rules, including their duty to make appropriate inquiry. In this connection, brokers and dealers should be aware that the submission or publication of a quotation at a price which does not bear a reasonable relationship to the nature and scope of the issuer's business or its financial status or experience, may constitute a part of a fraudulent or manipulative scheme.

STATUTORY BASIS

The Securities and Exchange Commission, acting pursuant to the provisions of the Securities Exchange Act of 1934, and particularly Sections 15(c)(2), 17(a), and 23(a) thereof, and deeming it in the public interest and for the protection of investors, hereby adopts Rule 15c2-11 as set forth below, effective December 13, 1971.

TEXT OF RULE 15c2-11

Rule 15c2-11. Initiation or Resumption of Quotations Without Specified Information

(a) It shall be a fraudulent, manipulative, and deceptive practice within the meaning of Section 15(c)(2) of the Act, for a broker or dealer to publish any quotation for a security or, directly or indirectly, to submit any such quotation for publication, in any quotation medium (as defined in this rule) unless:

(1) the issuer has filed a registration statement under the Securities Act of 1933 which became effective less than 90 calendar days prior to the day on which such broker or dealer publishes or submits the quotation to the quotation medium, *provided* that such registration statement has not thereafter been the

subject of a stop order which is still in effect when the quotation is published or submitted, and such broker or dealer has in his records a copy of the prospectus specified by Section 10(a) of the Securities Act of 1933; or

(2) the issuer has filed a notification under Regulation A under the Securities Act of 1933 which became effective less than 40 calendar days prior to the day on which such broker or dealer publishes or submits the quotation to the quotation medium, provided that the offering circular provided for under Regulation A has not thereafter become the subject of a suspension order which is still in effect when the quotation is published or submitted, and such broker or dealer has in his records a copy of such offering circular; or

(3) (A) the issuer is required to file reports pursuant to Section 13 or 15(d) of the Act, or is the issuer of a security covered by Section 12(g)(2)(B) or (G) of the Act, and

(B) the broker or dealer has a reasonable basis for believing that the issuer is current in filing the reports required to be filed at regular intervals pursuant to Section 13 of 15(d) of the Act, or, in the case of insurance companies exempted from Section 12(g) of the Act by subparagraph 12(g)(2)(G) thereof, the annual statement referred to in Section 12(g)(2)(G)(i) of the Act; and

(C) the broker or dealer has in his records the issuer's most recent annual report filed pursuant to Section 13 of 15(d) of the Act, or the annual statement in the case of an insurance company not subject to Section 12(g) of the Act, together with any other reports required to be filed at regular intervals under such provisions of the Act which have been filed by the issuer after such annual report or annual statement; or

(4) such broker or dealer has in his records, and shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer, the following information (which shall be reasonably current in relation to the day the quotation is submitted), which he has no reasonable basis for believing is not true and correct or reasonably current, and which was obtained by him from sources which he has a reasonable basis for believing are reliable: (1) the exact name of the issuer and its predecessor (if any); (2) the address of its principal executive offices; (3) the state of incorporation, if it is a corporation; (4) the exact title and class of the security; (5) the par or stated value of the security; (6) the number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year; (7) the name and address of the transfer agent; (8) the nature of the issuer's business; (9) the nature of products or services

offered; (10) the nature and extent of the issuer's facilities; (11) the name of the chief executive officer and members of the board of directors; (12) the issuer's most recent balance sheet and profit and loss and retained earnings statements; (13) similar financial information for such part of the two preceding fiscal years as the issuer or its predecessor has been in existence; (14) whether the broker or dealer or any associated person is affiliated, directly or indirectly with the issuer; (15) whether the quotation is being published or submitted on behalf of any other broker or dealer, and, if so, the name of such broker or dealer; and, (16) whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 per cent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person. If such information is made available to others upon request pursuant to this subparagraph, such delivery, unless otherwise represented, shall not constitute a representation by such broker or dealer that such information is true and correct, but shall constitute a representation by such broker or dealer that the information is reasonably current in relation to the day the quotation is submitted, that he has no reasonable basis for believing the information is not true and correct, and that the information was obtained from sources which he has a reasonable basis for believing are reliable.

(b) With respect to any security the quotation of which is within the provisions of this rule, the broker or dealer submitting or publishing such quotation shall maintain in his records information regarding all circumstances involved in the submission of publication of such quotation, including the identity of the person or persons for whom the quotation is being submitted or published and any information regarding the transaction provided to the broker or dealer by such person or persons.

(c) The broker or dealer shall maintain in writing as part of his records the information described in paragraphs (a) and (b), and any other information (including adverse information) regarding the issuer which comes to his knowledge or possession before the publication or submission of the quotation, and preserve such records for the periods specified in Rule 17a-4.

(d) For any security of an issuer included in paragraph (a)(4), the broker or dealer submitting the quotation shall furnish to the inter-dealer-quotation-system (as defined below), in such form as such system shall prescribe, at least 2 days before the quotation is published or submitted, the information regarding the security and the issuer which such broker or dealer is required to maintain pursuant to said paragraph (a)(4).

(e) For purposes of this rule:

(1) "Quotation medium" shall mean any "inter-dealer quotation system" or any publication or electronic communications network or other device which is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell.

(2) "inter-dealer quotation system" shall mean any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers.

(3) except as otherwise specified in this rule, "quotation" shall mean any bid or offer at a specified price with respect to a security.

(f) The provisions of this rule shall not apply to:

(1) the publication or submission of a quotation respecting a security admitted to trading on a national securities exchange and which is traded on such an exchange on the same day as, or on the business day next preceding, the day the quotation is published or submitted.

(2) the publication or submission of a quotation for securities of foreign issuers exempt from Section 12(g) of the Act by reason of compliance with the provisions of Rule 12g3-2(b).

(3) the publication or submission of a quotation respecting a security which has been the subject of both bid and ask quotations in an inter-dealer quotation system at specified prices on each of at least twelve days within the previous thirty calendar days, with no more than four business days in succession without such a two-way quotation.

(g) The requirement in subparagraph (a)(4) that the information with respect to the issuer be "reasonably current" will be presumed to be satisfied, unless the broker or dealer has information to the contrary, if:

(1) the balance sheet is as of a date less than 16 months before the publication or submission of the quotation, the statements of profit and loss and retained earnings are for the 12 months preceding the date of such balance sheet, and if such balance sheet is not as of a date less than 6 months before the publication or submission of the quotation, it shall be accompanied by additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than 6 months before the publication or submission of the quotation.

(2) other information regarding the issuer specified in subparagraph (a)(4) is as of a date within 12 months prior to the publication or submission of the quotation.

(h) This rule shall not prohibit any publication or submission of any quotation if the Commission, upon written request or upon its own motion, exempts such quotation either unconditionally or on specified terms and conditions, as not constituting a fraudulent, manipulative or deceptive practice comprehended within the purpose of this rule.

By the Commission.

Theodore L. Humes
Associate Secretary

NOTICE

In corresponding with the Commission about mailing list changes and delisting, please include ALL MAILING LIST CODES AND SYMBOLS appearing in your address as presently shown.

REGULATION OF THE COMPENSATION OF SECURITIES DEALERS*

David L. Ratner†

TABLE OF CONTENTS

I. SOURCES OF INCOME OF BROKER-DEALERS 349
II. STOCK EXCHANGE TRANSACTIONS 350
A. *Fixed Minimum Commission Rates* 350
B. *Rates and Services to Non Member Professionals* 354
C. *Recent Developments Regarding Commission Rates* 356
1. *Institutional Investors and the Growth of "Give-Ups"* 356
2. *The NYSE Proposal and the SEC Response* 357
3. *The Public Hearing on Commission Rates* 358
D. *Rates and Services to Small Customers* 360
E. *Setting of Minimum Commission Rates* 360
1. *Action by the Exchanges* 360
2. *Review by the SEC* 361
3. *Antitrust Questions* 364
III. OVER-THE-COUNTER TRANSACTIONS 368
A. *Compensation for Acting as Customer's Agent* 369
B. *Compensation for Dealing with Customer as Principal* 369
1. *Limitations on Mark-Ups* 370
2. *Special Study Recommendations* 373
IV. SALE OF MUTUAL FUND SHARES 375
A. *Method of Fixing Sales Loads* 375
B. *Level of Sales Loads* 375
C. *Quantity Discounts* 378
D. *Periodic Payment Plans* 380
E. *Additional Compensation for Sale of Mutual Fund Shares* 382
V. UNDERWRITING 384
A. *Fixed Public Offering Price* 384
B. *Level of Underwriting Compensation* 385
VI. INTEREST INCOME 387
A. *Disclosure of Interest Rate* 387
B. *Use of Customers' Free Credit Balances* 388

The compensation structure of the securities business is being challenged from many directions. The Justice Department has questioned the need for fixed minimums on stock exchange commissions

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* As noted in the opening paragraph, this area of regulation is in a period of rapid change; the statements herein are current as of January 20, 1970.

A revised version of this article is expected to be included in a book on the regulation of securities dealers, to be published by McGraw-Hill.

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The author wishes to express his appreciation to Peter Sterling, of the Cornell Law School class of 1970, for his research assistance in the preparation of this article.

and the Securities and Exchange Commission is holding extensive hearings to determine whether and in what form they can be justified. Congress is considering legislation to control sales loads on mutual fund shares. The National Association of Securities Dealers found "unfair or unreasonable" underwriting compensation in more than fifteen percent of the new issues it reviewed in 1968. And the securities business itself is complaining that its charges on small transactions are inadequate to cover its costs.

The following summary of the complex of regulations governing compensation in the securities business may help to explain some of the dissatisfaction with the current situation, as well as pointing toward possible areas for change.

I

Sources of Income of Broker-Dealers

The securities business is essentially a service business. Some of the transactions in which broker-dealer firms engage take the form of principal transactions, but basically such firms act as intermediaries between buyers and sellers of securities—members of the public, institutional investors, and the issuers of the securities themselves. Broker-dealers receive compensation from a variety of activities, each of which is subject to distinct regulations and limitations. A study done for the National Association of Securities Dealers (NASD) showed that its members in 1964 obtained about forty-four percent of their income from stock exchange commissions, seventeen percent from over-the-counter transactions, eight percent from mutual fund sales activities, six percent from corporate underwritings, and the remaining twenty-five percent from miscellaneous other sources, including interest on customers' margin accounts, commodity transactions, advisory fees, and service charges.[1] The compensation mix varied greatly from firm to firm, with the larger firms deriving a greater proportion of their income from stock exchange commissions, the small-to-medium firms deriving the greatest proportion from over-the-counter activities, and the smallest firms receiving most of their income from the retailing of mutual fund shares.[2]

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1 Booz, Allen & Hamilton, Inc., Over-the-Counter Markets Study 13 (1966) [hereinafter cited as OTC Study]. *See also* New York Stock Exchange, 1969 Fact Book 57.

2 OTC Study 13.

II

Stock Exchange Transactions

A. *Fixed Minimum Commission Rates*

Commissions on stock exchange transactions are based on schedules of minimum commissions established by the national securities exchanges and binding on their members. The commission rate schedules of the various exchanges are substantially identical, so that a firm that is a member of several exchanges must charge the same commission to a customer for a particular transaction regardless of on which exchange it is executed.[3] Since New York Stock Exchange (NYSE) transactions account for approximately eighty percent of the dollar volume of all exchange trading,[4] the following discussion is based on the NYSE rules, with appropriate indications of variations to be found in the rules of other exchanges.

1. *Scope of Restriction*

The stock exchange rules prescribe minimum commission rates, and there is generally no legal restriction against members charging higher rates. As a practical matter, however, member firms seldom charge more than the minimum rate for services to which the rate schedule applies.[5]

The commission rate schedule is divided into two distinct parts: (*1*) a schedule of rates to be charged by members to non-members for effecting a complete transaction on the exchange[6] and (*2*) a schedule

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[3] The New York Stock Exchange [NYSE], American Stock Exchange [AMEX], Midwest Stock Exchange [MSE], and Pacific Coast Stock Exchange [PCSE] rules state that in the event of a conflict as to commission rates to be charged, their members may follow the rates prescribed by the exchange where the transaction occurred. NYSE Const. art. XV, § 1; Amex Const. art. VI, § 1; MSE rules art. XXVIII, rule 19; PCSE rule IV, § 3(f). A NYSE member which is also a member of a regional exchange (*i.e.*, an exchange located outside the City of New York) is permitted to deal in all securities listed or traded on such other exchange, including securities dually listed on the NYSE. NYSE Const. art. XIV, § 8. The AMEX rules also permit member trading of dually-listed AMEX securities outside the City of New York. Amex Const. art. V, § 4(g). The SEC found in 1941 that "irreparable damage" would result to the regional exchanges if the NYSE prevented its members from dealing on another exchange in securities dealt in on the NYSE, and ordered the NYSE constitution amended to permit such dealing. The Rules of the NYSE, 10 S.E.C. 270 (1941) (The Multiple Trading Case).

[4] SEC Securities Exchange Act Release No. 8239, at 4 n.2 (Jan. 26, 1968).

[5] *See generally* Association of Stock Exchange Firms, Commission Tables for Transactions on the New York Stock Exchange and the American Stock Exchange.

[6] "Non-member" is usually defined as any party not a member or allied member of an exchange, and includes professional brokers as well as ordinary customers. NYSE Const. art. I, § 3(e).

of rates to be charged by members to one another for the various steps involved in the complete transaction.

The minimum rate to be charged to non-members applies to all non-members, including those engaged in the securities business. Since the rules of the exchanges generally prohibit members from executing transactions in listed stocks off the floor of an exchange,[7] this in effect places a minimum on the commission that a member firm may charge a non-member firm for effecting a transaction in a listed security.

2. *Non-Member Rates*

a. *Services Covered.* The minimum rate to be charged to a non-member is an all-inclusive rate, covering the execution and clearance of the transaction, arrangements for the registration and delivery of the securities, and basic research and custodial services. The exchanges generally impose restrictions, however, on the additional services that a member firm may perform for a customer without charging additional fees,[8] on the ground that these may constitute rebates of the minimum commission.[9]

If both the buyer and seller are non-members, two full commissions must be charged, even where the same firm acts as broker for both parties to the transaction.

b. *Basic Rate.* The commission to be charged to a non-member for the execution of a transaction in listed stocks, rights, or warrants is based on the "money involved" in a "single transaction." On stocks selling for one dollar per share and above, the basic rate is three dollars plus

2% on first $400 of money involved, plus
1% on next $2,000 of money involved, plus
1/2% on next $2,600 of money involved, plus
1/10% on money involved above $5,000.[10]

Under this formula, the minimum commission for buying or sell-

[7] *See* NYSE rules 394, 395, 396; AMEX rule 187; MSE rules art. XXII, rule 6; PCSE rule XIII, § 2.

[8] Examples of prohibited arrangements are unusual interest rates or money advances or assumption of stamp taxes or office expenses by a member, NYSE rule 369; certain types of statistical and investment advisory services, NYSE rule 440; supplementary material and certain office space arrangements, NYSE rule 343. The regional exchange rules contain similar prohibitions. AMEX CONST. art. VI, § 5; MSE rules art. XXVIII, rule 16; PCSE CONST. art. XIV, § 1.

[9] *See* NYSE CONST. art. XV, § 1.

[10] NYSE CONST. art. XV, § 2(a)(1); AMEX CONST. art. VI, § 2(a); MSE rules art. XXVIII, rule 2(a); PCSE rule IV, § 1(a)(1).

ing one hundred shares of a high-priced stock is greater than the commission for buying or selling one hundred shares of a low-priced stock but is a smaller percentage of the "money involved." For example, the minimum commission for buying or selling one hundred shares of stock selling at $20 a share is $27, or 1.35 percent of the money involved; for one hundred shares of a $40 stock, it is $39, or 0.98 percent of the money involved; and for one hundred shares of an $80 stock, it is $47, or 0.5 percent of the money involved.

Although this formula on its face appears to provide a substantially lower rate for large transactions, each one hundred shares or less included in an order is deemed to be a separate, "single transaction" to which the formula is to be applied.[11] Thus the minimum commission on a single order to buy or sell 200 shares of a $40 stock is $78, or two times $39, and on a single order to buy or sell 1,000 shares it is $390, or ten times $39. A customer who wants to invest $4,000, therefore, must pay a commission of $54 if he buys 200 shares of a $20 stock as against $39 if he buys one hundred shares of a $40 stock.

c. *Lower Rate on Large Orders.* Prior to December 5, 1968, the above rate applied to all orders without limitation as to size, so that the minimum commission on a single order to buy or sell 100,000 shares of a particular stock was 1,000 times the commission on one hundred shares of the same stock. However, the volume of large block transactions in listed stocks,[12] particularly by institutional investors,[13] had been rapidly increasing, and the SEC's public hearing on stock exchange commission rates disclosed that substantial portions of the commissions on institutional business were being "given up" to broker-dealer firms and other persons who had no connection with the execution of the transactions.[14] Consequently, the national securities exchanges were required to put into effect on December 5, 1968, an "interim" revised minimum commission rate schedule providing substantially lower rates for the portion of an order that exceeds 1,000 shares.[15] The modified rate for each "single transaction" of one hundred shares or less after the first 1,000 shares is:

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11 NYSE CONST. art. XV, § 2(d)(1); AMEX CONST. art. VI, § 2(f); MSE rules art. XXVIII, rule 2(d)(1); PCSE rule IV, § 1(b).

12 In 1968 on the NYSE there were 11,254 transactions involving 10,000 or more shares, accounting for 10% of reported volume. NYSE, 1968 ANN. REP. 15.

13 It is estimated that at present approximately 50% of non-member volume on the NYSE is transacted by institutions. SEC, 1968 ANN. REP. 3.

14 *See* text accompanying notes 38-62 *infra*.

15 NYSE CONST. art. XV, § 2(a)(2); AMEX CONST. art. VI, § 2(a)(2); MSE rules art. XXVIII, rule 2(a)(2); PCSE rule IV, § 1(a)(2). It was estimated that the new volume discount on orders over 1,000 shares would reduce brokerage commissions about $150 million in 1969. SEC, 1968 ANN. REP. 2.

Money Involved	*Commission*
$100 to $2,800	1/2% of money involved plus $4
$2,800 to $3,000	compute as for $2,800
$3,000 to $9,000	1/2% of money involved plus $3
Above $9,000	1/10% of money involved plus $39

Thus the minimum commission on a purchase or sale of 10,000 shares of a $40 stock is now $2,460 [(10 × $39) + (90 × $23)] as compared with $3,900 (100 × $39) under the previous formula. The interim rate also provides that the minimum commission on any order, no matter how large, cannot exceed $100,000.[16]

An "order" is deemed to include all purchases or sales for one account, of a single security, on the same day, pursuant to a single order.[17] When a large order from a customer is executed over a period of several days, each day's executions are considered a separate "order" for the purpose of computing the minimum commission. Where parts of a single order from a customer to a broker are executed on different exchanges, the regional stock exchanges will permit the lower rate to be charged on the portion in excess of 1,000 shares regardless of the exchange on which executed.[18]

d. *Odd Lots.* The minimum commission on the purchase or sale of less than one hundred shares[19] is generally fixed at two dollars less than the commission on a one hundred share transaction involving the same amount of money. An odd-lot transaction is automatically executed between the customer and the odd-lot dealer at the price of the next round-lot transaction in the stock. In addition to the commission charged by the customer's broker, the odd-lot dealer charges the customer a "differential" of one-fourth point (25 cents) on stocks selling at $55 or higher and one-eighth point (12.5 cents) on stocks selling below $55.[20]

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16 NYSE CONST. art. XV, § 2(f); AMEX CONST. art. VI, § 2(h); MSE rules art. XXVIII, rule 2(f); PCSE rule IV, § 1(d). One NYSE member advertised that it acted as broker for both buyer and seller in a NYSE transaction on May 4, 1967, involving 585,600 shares of Sperry Rand at a price of $30.75 a share. N.Y. Times, May 8, 1967, at 64. Under the then-existing rates, the minimum commissions to be charged by the firm on that transaction totaled $402,600. Under the new rate schedule, the minimum commissions would total $200,000.

17 NYSE CONST. art. XV, §§ 2(d)(2), (3); AMEX CONST. art. VI, § 2(f)(2); MSE rules art. XXVIII, rule 2(d)(w); PCSE rule IV, § 1(b)(2).

18 *E.g.*, MSE rules art. XXVIII, rule 2(j).

19 For minimum rates on 100-share lots, see text accompanying notes 10-11 *supra*. A "unit of trading" is usually 100 shares and any number below 100 is an odd lot. However, certain stocks have "units of trading" of 10 or even 50 shares as fixed by the various exchanges. NYSE rule 55; AMEX rule 120; MSE rules art. IV, rule 6; PCSE rule 1, § 7(a).

20 NYSE rule 125. The present $55 "break point" was adopted by the NYSE in June 1966. Between 1942 and 1966, the "break point" was $40 and had been established not by the Exchange but by the two NYSE member firms that handle all odd-lot transactions on

e. *Special Types of Securities and Transactions.* Special rules prescribe minimum commission rates for shares selling below one dollar,[21] for bonds,[22] for "when issued" or "when distributed" transactions,[23] and other special circumstances.

3. *Intra-Member Rates*

Exchange rules also prescribe minimum commissions to be charged by members to other members for various services in connection with the execution of transactions. The minimum commissions for floor brokerage and clearance range from 1.85 cents a share for shares selling between one dollar and two dollars to 9.30 cents a share for shares selling at $200 and above;[24] minimum commissions for floor brokerage alone range from 1.15 cents a share for shares selling between one dollar and two dollars to 4.65 cents a share for shares selling at $200 and above;[25] and minimum clearing charges range from 0.30 cents a share for shares selling between fifty cents and one dollar to 3.00 cents a share for shares selling at $50 and above.[26]

B. *Rates and Services to Non-Member Professionals*

The NYSE rules prohibit member firms from charging lower commissions to non-member broker-dealers than to other customers, and the rules endeavor to set precise limitations on the services member firms may perform free or at less than cost for non-member professionals.[27] For example, there are specific limitations on the furnishing of office space, investment advice, and private wire services, as well as a general

that Exchange. A class action is presently pending against those two firms, alleging that they combined and conspired to monopolize odd-lot trading and fixed the odd-lot differential at an excessive amount in violation of the Sherman Act. Eisen v. Carlisle & Jacquelin, 391 F.2d 555 (2d Cir. 1968). The "break point" on AMEX transactions is still $40. For the rules on other exchanges, see AMEX rule 204; MSE Summary of Rules, § 14; PCSE rule 1, § 8.

[21] NYSE CONST. art. XV, § 2(a)(3); AMEX CONST. art. VI, § 2(a)(3); MSE rules art. XXVIII, rule 2(c)(2); PCSE rule IV, § 1(a)(3).

[22] NYSE CONST. art. XV, § 3; AMEX CONST. art. VI, § 2(d); MSE rules art. XXVIII, rule 3; PCSE rule IV, § 1(f).

[23] NYSE CONST. art. XV, § 5; AMEX CONST. art. VI, § 2(i); MSE rules art. XXVIII, rule 5.

[24] NYSE CONST. art. XV, § 2(b)(1); AMEX CONST. art. VI, § 2(b); MSE rules art. XXVIII, rules 2(b), (c)(1); PCSE rule IV, § 4(a).

[25] NYSE CONST. art. XV, § 2(b)(3); AMEX CONST. art. VI, § 2(b); MSE rules art. XXVIII, rule 2(c)(1); PCSE rule IV, § 4(b).

[26] NYSE CONST. art. XV, § 4; AMEX CONST. art. VI, § 2(b); MSE rules art. XXVIII, rule 2(b); PCSE rule IV, § 4(a). NYSE interpretation permits member firms to charge correspondents not less than 21% of the non-member rate rather than computing the special rate for each transaction.

[27] *See* NYSE CONST. art. I, § 3(e); *id.* art. XV, § 1.

prohibition against offering other types of services unless the cash compensation is sufficient to cover all direct and indirect costs of the service or unless the service is contingent on the non-member giving the member firm commission business and the cash charge covers all costs of creating, producing, and distributing the service.[28]

1. *Reciprocal Business Arrangements*

Since these rules effectively prevent NYSE non-members from deriving direct compensation from transactions in listed securities which are executed for their customers on the NYSE,[29] reciprocal dealing arrangements have been established between NYSE-member and regional exchange-member firms. The NYSE-member firm, which is also a member of a regional exchange, usually agrees to give one dollar of commission to the regional exchange-member firm for each two dollars in commissions on transactions in listed securities it receives from the latter.[30] Prior to December 5, 1968, reciprocity often took the form of the NYSE-member firm executing transactions in dually-listed securities on a regional exchange of which it was also a member, and "giving up" a portion of the commission to the regional firm.[31] Since the prohibition on "give-ups,"[32] reciprocity has taken the form of NYSE members placing orders with regional exchange members for execution of transactions in dually-listed stocks on the regional exchanges.[33] In May 1969, however, the NYSE advised the SEC that some of these reciprocal arrangements appeared to violate the NYSE rules against rebates and that it was considering prohibiting reciprocal arrangements.[34]

2. *Discounts*

The NYSE recently announced that it is considering a rule change permitting its members to give a discount, amounting to perhaps one-

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[28] *See* note 8 *supra*.

[29] The non-member must pay the member the NYSE minimum commission and will usually receive no more than the minimum commission from his own customer.

[30] These arrangements in 1968 resulted in the NYSE giving out $19.9 million in regional business in return for $34.4 million in NYSE business. Wall St. J., June 10, 1969, at 4, col. 1.

[31] Wall St. J., July 3, 1968, at 17, col. 3.

[32] NYSE Const. art. XV, § 1; Amex Const. art. VI, § 1; MSE rules art. XXVIII, rule 12; PCSE rule IV, § 1(a). *See* text accompanying notes 38-62 *infra*.

[33] Wall St. J., Jan. 9, 1969, at 1, col. 6. *See also* note 54 *infra* and accompanying text.

[34] Wall St. J., May 5, 1969, at 6, col. 2. NYSE rule 382 requires a member to file written information concerning any direct or indirect reciprocal arrangement related to NYSE listed commission business involving any NYSE member, broker or dealer, bank, trust company, mutual fund, etc. Each arrangement is subject to Exchange approval.

third of the commission, to "qualified" non-member broker-dealers.[35] The American Stock Exchange (AMEX) already admits qualified broker-dealers to "associate membership" entitling them to have transactions executed on the AMEX at special intra-member rates that range from about twenty percent to one hundred percent above the rates charged to regular members for comparable services[36] but are considerably below the rates charged to non-members. For example, the commission charged to an associate member for execution and clearance of one hundred shares of a $20 stock is $10.75, as compared with $6.90 to a regular member and $27 to a non-member. The initiation fee for an associate member is five percent of the last sale price of a regular membership, but not less than $1,000.[37]

C. *Recent Developments Regarding Commission Rates*

1. *Institutional Investors and the Growth of "Give-Ups"*

Prior to December 5, 1968, the minimum commissions on large transactions were simply multiples of the minimum commissions for one-hundred-share transactions.[38] During the 1960's, the rapidly growing participation in the stock market by institutions and the concomitant increase in large block trading began to provide stock exchange member firms with commissions substantially in excess of the prices at which they would have been willing to execute the transactions in a competitive service market. Exchange rules prohibited member firms from reducing their rates to large customers or providing offsetting services,[39] but nothing prevented member firms from sharing their commissions with other member firms. Managers of certain large institutional investors, particularly the mutual funds, began to direct brokers to "give up" a portion of their commissions on fund portfolio transactions to other member firms.[40] These other member firms might be firms that had provided the fund with investment advice or, to an increasing extent, firms that had actively sold

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[35] Wall St. J., June 10, 1969, at 4, col. 1.

[36] AMEX CONST. art. IV, § 1(c).

[37] *Id.* art. VI, § 2(b). The Pacific Coast Stock Exchange grants "preferred rates" (75% of the non-member minimum) to approved non-members who are members of a national securities exchange or national securities association, or who are engaged in the banking business. PCSE rule IV, § 2. A list of approved non-members is published by the Exchange.

[38] *See* note 11 *supra* and accompanying text.

[39] *See* notes 9 & 27 *supra*.

[40] The give-ups were usually at least 60%, and often 70% or more, of the commission received by the broker. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, *published as* H.R. REP. No. 2337, 89th Cong., 2d Sess. 170 (1966) [hereinafter cited as MUTUAL FUND REPORT].

the fund's shares.[41] Initially the technique could be used only to compensate stock exchange member firms for sales of mutual fund shares, but, commencing in 1950, six of the seven regional exchanges amended their rules to permit members to "give up" part of their commissions to any member of the NASD. These amendments caused a substantial amount of business in dually-listed stocks to be diverted to the regional exchanges for the purpose of compensating non-member broker-dealers for mutual fund sales.[42] The NYSE did not permit its members to split commissions with non-NYSE members on NYSE transactions,[43] but evidence introduced at the SEC hearing on stock exchange commission rates indicated that some member firms had channeled dollars to non-members by crediting them with arbitrary amounts on unrelated transactions in over-the-counter securities.[44]

In 1965 two of the largest investment advisers, which distributed fund shares largely through their own organizations and therefore had no incentive to utilize brokerage commissions to reward dealers who sold fund shares, established broker-dealer subsidiaries that were admitted to membership on the Pacific Coast Stock Exchange (PCSE). These firms executed some transactions for the funds on the PCSE, but their principal purpose was to receive reciprocal business and give-ups from firms that executed transactions for the funds on other exchanges, principally the NYSE. All of the net profit from this operation, in one case, and approximately half of the net profit, in the other case, was returned to the funds in the form of reduction in the management fee paid to the adviser.[45]

2. *The NYSE Proposal and the SEC Response*

In January 1968 the NYSE proposed to the SEC a five-point revision in its commission rate structure. The proposal envisioned unspecified volume discounts, continuation of customer-directed give-ups with a limitation on the percentage that might be given up, prohibition of "rebative" reciprocal practices, discounts for "qualified" non-member broker-dealers, and limitation of membership and discounts on all exchanges to "bona fide broker-dealers."[46] The SEC responded by inviting public comment on the NYSE proposals and on a proposed SEC rule that prohibited mutual fund managers from directing any give-up

[41] *Id.* at 164-67.
[42] *Id.* at 171.
[43] NYSE CONST. art. XV, § 8.
[44] *See* Washington Post, July 2, 1968, at D6, col. 1.
[45] MUTUAL FUND REPORT 109, 172.
[46] SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968).

of commissions on mutual fund portfolio transactions unless the benefits of the give-up accrued to the fund and its shareholders.[47]

Among the comments received by the SEC was a lengthy memorandum from the Department of Justice, which concluded that "the maintaining of an effective auction market, does not appear to justify the fixing of minimum commission rates by the NYSE" and that "rate fixing is plainly unnecessary in institutional trading and, generally, for large transactions."[48] On May 28, 1968, the SEC requested the NYSE, pursuant to section 19(b) of the Exchange Act, to adopt as an interim measure either a specified revised commission rate schedule providing reduced rates for the portion of any order in excess of 400 shares or a rule eliminating minimum rates of commission on orders in excess of $50,000.[49] At the same time, the SEC announced that it was ordering a general public investigatory hearing into the commission rate structure of the national securities exchanges.[50]

On August 8, 1968, the NYSE proposed an alternative interim rate, providing reduced rates for that portion of any order in excess of 1,000 shares.[51] On August 30 the SEC accepted the NYSE revision,[52] which, after approval by the NYSE membership, went into effect on December 5, 1968.[53] The regional exchanges each adopted substantially identical rate structures. At the same time, each of the exchanges amended its constitution or rules to prohibit give-ups by providing that

> [n]o member . . . shall, in consideration of the receipt of business . . . and at the direct or indirect request of a non-member or by direct or indirect arrangement with a non-member, make any payment or give up any work or give up all or any part of any commission or other property to which such member . . . is or will be entitled.[54]

3. *The Public Hearing on Commission Rates*

The SEC is continuing its public hearing into the commission rate structure. The principal alternatives under consideration for dealing with the problem of commission rates on large transactions are: *(1)* continuation of minimum commissions, either in the present or

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[47] *Id.*

[48] Comments of the United States Dep't of Justice on SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968).

[49] SEC Securities Exchange Act Release No. 8324 (May 28, 1968).

[50] *Id.*

[51] CCH Fed. Sec. L. Rep. ¶ 77,585 (1968).

[52] SEC Securities Exchange Act Release No. 8399 (Sept. 4, 1968).

[53] For description of the revised rate schedule, see text accompanying notes 12-18 *supra*.

[54] *See, e.g.*, NYSE Const. art. XV, § 1; Amex Const. art. VI, § 1.

a modified form; (2) elimination of minimum commissions on large transactions; and (3) expanding large investors' opportunity to recapture a portion of their brokerage costs through membership on exchanges. The NYSE has consistently opposed eliminating minimum commissions on large transactions, on the ground that "[n]egotiated commission rates would minimize the incentive for members to conduct business primarily on the floor of the NYSE . . . [and] would divert trading into new and splintered over-the-counter markets."[55] The Justice Department and a number of economists, on the other hand, argue that fixing minimum rates in the securities industry is not only unnecessary,[56] but presents peculiar difficulties because of the great variations in size, efficiency, and product mix of brokerage firms.[57]

The NYSE also opposes institutional membership,[58] which many brokers believe would deprive them of their best customers. Its announced reason is that "[g]ranted seats on the exchange, the institutions might soak up funds normally invested by individuals and sharply cut the small lot trading that provides the market's liquidity."[59] Managers of some investment institutions, on the other hand, believe they should be entitled to join exchanges, at least to the extent of enabling them to obtain the lower commission rates available to members.[60]

The NYSE has announced that it hopes to submit a new rate schedule to the SEC early in 1970.[61] In the meantime, however, the SEC has invited argument on the question whether, if minimum commission rates are to be retained, they should continue to fix an "all-inclusive" rate for non-members or should be limited to "such relatively standardized services as 'execution' and 'clearance,'" as in the case of intra-member rates.[62]

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55 NYSE, ECONOMIC EFFECTS OF NEGOTIATED COMMISSION RATES ON THE BROKERAGE INDUSTRY, THE MARKET FOR CORPORATE SECURITIES, AND THE INVESTING PUBLIC 11 (1968).

56 N.Y. Times, May 2, 1969, at 59, col. 1.

57 Memorandum of the United States Dep't of Justice on the Fixed Minimum Commission Rate Structure 99-106 (Jan. 1969) [hereinafter cited as Justice Dep't Memo].

58 N.Y. Times, Oct. 30, 1969, at 67, col. 1. *See also id.*, May 3, 1969, at 47, col. 8. The Justice Department's Antitrust Division has recently challenged the NYSE position that restrictions on public ownership of member firm shares should exist to prevent institutional investors from gaining membership on the exchange. Wall St. J., Nov. 18, 1969, at 3, col. 2.

59 Wall St. J., Jan. 23, 1969, at 3, col. 2.

60 *See* N.Y. Times, Nov. 17, 1969, at 73, col. 3.

61 NYSE Special Membership Bull., in BNA, SEC. REG. & L. REP., No. 26, at x-3 (Nov. 26, 1969).

62 SEC Securities Exchange Act Release No. 8791 (Dec. 31, 1969).

D. *Rates and Services to Small Customers*

The same rigid structure which makes large transactions highly profitable produces, at the other end of the scale, commissions on small transactions which many brokers assert are insufficient to cover the costs of handling them. There is no legal prohibition against charging more than the minimum commission rates on exchange transactions, but individual brokers are unwilling to do so.[63]

Brokers and exchange officials have suggested modifications in the commission rate structure to deal with this problem, either increasing the minimum charge, or the "single transaction" charge, or imposing separate charges for the maintenance of an account or for specific services such as safeguarding customers' securities.[64] Pending such action, many brokerage houses have imposed minimum requirements for purchases by new customers. A survey by the NYSE in May 1969 showed that fourteen percent of the 514 firms responding required a new customer to make a minimum purchase ranging from $1,500 to $250,000; fifteen percent required a minimum purchase of $1,000, and five percent had minimums ranging from $100 to $500.[65] No statute or exchange rule requires brokers to accept small customers, but exchange officials consider rejecting small accounts inconsistent with their policy of interesting small investors in the securities market.[66] The President of the NYSE has stated, however, that "one of the key changes in the commission structure [to be submitted to the SEC in early 1970] must be an increase in rates on small orders."[67]

E. *Setting of Minimum Commission Rates*

1. *Action by the Exchanges*

Since trading on the NYSE accounts for the great majority of stock exchange commission business,[68] and since the membership of

[63] N.Y. Times, May 3, 1969, at 47, col. 8.

[64] Wall St. J., April 11, 1969, at 3, col. 2.

[65] Wall St. J., June 6, 1969, at 4, col. 4. More recently, several firms doing a large retail business have changed their method of compensating salesmen to make it less attractive for them to solicit small orders. *See* N.Y. Times, Dec. 15, 1969, at 77, col. 6; *id.* Dec. 16, 1969, at 67, col. 7.

[66] Ralph S. Saul, president of the AMEX, stated that a continuing rejection of smaller public transactions "could lead to further domination of the market by institutions—mutual funds, commercial banks, insurance companies and pension funds—with a corresponding loss of market liquidity." Wall St. J., April 11, 1969, at 3, col. 2.

[67] Address of Robert Haack, in BNA SEC. REG. & L. REP. No. 26, at x-1 (Nov. 26, 1969).

[68] *See* note 4 *supra* and accompanying text.

the NYSE overlaps that of the other exchanges to a large degree, the NYSE commission rate structure determines the pattern for the industry.

a. *Procedure.* The NYSE's basic commission rate structure is set forth in article XV of its constitution. Amendments to the constitution must be approved by a majority of the Board of Governors and by a majority of the members.[69] Since the product mix of NYSE members varies greatly from firm to firm, any change in the commission rate structure, other than an increase in the general level of rates, will be opposed by some group of members.[70] Each of the five changes in commission rates between 1934 and 1967 was recommended by a special committee of the NYSE and primarily involved an increase in the general level of rates, although limited structural changes were involved in some instances.[71]

b. *Standards.* The emphasis in the NYSE committee reports preceding the five rate increases was on the income received from commission business, the cost of doing such business, and the necessity for a "fair return."[72] The NYSE's ability to develop precise standards has been hampered by the heterogeneity of the member firms, the absence of a mandatory uniform system of accounts, and limited capacity to gather economic information.[73]

2. *Review by the SEC*

a. *Procedure.* Under section 19(b)(9) of the Exchange Act, the SEC is authorized to alter or supplement the rules of any exchange "in respect of . . . the fixing of reasonable rates of commission" if "after appropriate notice and opportunity for hearing, the Commission determines . . . that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange." Before altering or supplementing exchange rules, the SEC must first request the exchange to effect such changes itself.

The SEC has never exercised its authority under this section to

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69 NYSE CONST. art. XX. On the MSE and PCSE the Board of Governors has authority to set and change rates, and no amendment to the constitution or approval by the membership is necessary. PCSE CONST. art. XIV, § 1; MSE CONST. art. XII, § 2. The AMEX follows the NYSE pattern. AMEX CONST. art. XIII.

70 *See* Wall St. J., Oct. 21, 1968, at 34, col. 1; *id.* Jan. 23, 1969, at 2, col. 3.

71 REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2, at 329 (1963) [hereinafter cited as SPECIAL STUDY].

72 *Id.* at 333-37.

73 *Id.* at 337-43.

alter or supplement exchange rules governing commission rates.[74] The 1968 change in commission rates for large orders[75] was the first change resulting from a formal request by the SEC under section 19(b)(9),[76] although rate increases put into effect by the NYSE in 1942 and 1958 were modified in accordance with "recommendations" or "suggestions" by the SEC.[77]

Section 19(b) does not set forth any procedure for automatic SEC review of rule changes instituted by the exchange. In each of the four changes in commission rates between 1937 and 1953, the NYSE presented its proposals to the SEC and awaited the SEC's approval, or indication of lack of objection, before making any effort to put the rule changes into effect.[78] In 1958, however, the NYSE notified the SEC of proposed changes and eight days later submitted the proposed schedule to the membership for approval, without waiting for SEC reaction. The membership approved the rates, and they went into effect seven weeks after the notification to the SEC, despite the SEC's announcement of its intention to study their reasonableness.[79] The SEC completed its study several months later. The ensuing discussions resulted in the acceptance by the NYSE, in February 1959, of SEC suggestions to decrease certain commission rates at the lower range of the scale by approximately five percent and to eliminate the "round turn" discount adopted in 1953.[80]

In light of the 1958 experience, the *Special Study* recommended that "existing procedures should be modified to assure that proposed changes in rates will be submitted to the Commission adequately in advance of their proposed effectiveness."[81] Pursuant to this suggestion, the SEC in 1964 adopted rule 17a-8, requiring every exchange to file a report of any proposed rule change at least three weeks before any action is taken by the members or governing body of the exchange.[82]

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74 The only case in which such authority has been exercised was The Rules of the NYSE, 10 S.E.C. 270 (1941), described in note 3 *supra*.

75 *See* text accompanying notes 12-18 *supra*.

76 SEC Securities Exchange Act Release No. 8324 (May 28, 1968).

77 SPECIAL STUDY, pt. 2, at 330, 331, 344.

78 *Id.* at 344.

79 *Id.* at 345.

80 *Id.* at 332.

81 *Id.* at 351.

82 The adoption of rule 17a-8 was proposed early in 1964. SEC Securities Exchange Act Release No. 7218 (Jan. 9, 1964). It became effective April 6, 1964. SEC Securities Exchange Act Release No. 7253 (March 3, 1964).

If any substantive change is made in the proposal, it starts a new three-week period.[83]

b. *Standards*. Section 19(b) provides that the SEC may require such rule changes as "are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange." Section 19(b)(9) refers to the "fixing of *reasonable* rates of commission,"[84] but the *Special Study* noted the absence of any "comprehensive and consistent public articulation, on the part of the Exchange or the Commission, of the principles or criteria to be applied in interpreting the standard."[85] One can hope that the public hearing on the commission rate structure commenced in July 1968 will produce at least an attempt by the SEC to articulate these principles and criteria.

A related problem noted by the *Special Study* is the inadequacy of the data available to the SEC concerning the economics of the securities business.[86] Prior to 1968, the only information regularly available to the SEC was that voluntarily supplied by the NYSE on the basis of the income and expense reports submitted by its members. The *Special Study* found that despite improvements over the years, these reports failed to supply the data necessary to enable the SEC to discharge effectively its statutory obligation to review the "reasonableness" of commission rates.[87]

In June 1968 the SEC adopted a new rule 17a-10, requiring every registered broker-dealer carrying public customer accounts to file an-

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83 The *Special Study* also recommended consideration of the feasibility of providing for a refund or adjustment of any portion of a rate increase which is put into effect by an exchange and subsequently disapproved by the SEC. SPECIAL STUDY, pt. 2, at 351. No specific action has yet been taken by the SEC to implement this proposal.

With respect to the possible liability of an exchange and its members under the antitrust laws for rates established by an exchange and subsequently disapproved by the SEC on the ground that they are not "reasonable," see Sabre Shipping Corp. v. American President Lines, Ltd., 285 F. Supp. 949 (S.D.N.Y. 1968). In the *Sabre* case, involving the fixing of rates by a shipping conference, the court held, on a motion to dismiss, that the defendants enjoyed no immunity from antitrust laws notwithstanding a pending Federal Maritime Commission review of revised conference rates:

> The mere fact that agreements setting rates are permitted to take effect prior to approval, does not mean that irrespective of their effect on the commerce of the United States they may be enjoyed until the defendants are caught, only to be released from all past liability simply by discontinuing those rates.

Id. at 955. *See also* text accompanying notes 90-112 *infra*.

84 15 U.S.C. § 78s(b)(9) (1964) (emphasis added).

85 SPECIAL STUDY, pt. 2, at 343.

86 *Id.* at 342.

87 *Id.* at 342, 343

nual income and expense reports with the SEC or with either the NASD or a national securities exchange, which will transmit the reports to the SEC.[88] A report must be made for each calendar year, starting with 1969, and is due ninety days after the end of the year. As a result of industry opposition to providing the SEC with specific information about individual firms, the rule provides that, in forwarding copies of the reports filed by their members to the SEC, the exchanges and the NASD may omit the names and addresses of the members for whom the reports are transmitted.

The rule requires the filing of one of three alternative forms. The most comprehensive form is to be filed by firms that are members of the NYSE or have gross securities income of $1,000,000 or more during the year. An intermediate form is to be filed by non-members of the NYSE who have gross securities income between $100,000 and $1,-000,000. The simplest form is to be filed by non-members of the NYSE who have gross securities income between $20,000 and $100,000 or have gross securities income of $20,000 or more and derived more than eighty percent of such income from retail mutual fund sales, municipal bonds, fractional interests in oil, gas or other mineral rights, variable annuities, savings and loan placements, real estate syndications, or any combination of these. Firms that have gross securities income of less than $20,000, that effect transactions only for other brokers or dealers, or that are engaged only in wholesale distribution of mutual fund shares or variable annuities are required to file only an introductory page containing very limited information. The new reports are designed "to provide needed comprehensive financial data on a continuing basis so that up-to-date information will be readily available to the SEC, the exchanges, and the NASD in connection with the performance of their respective responsibilities."[89]

3. *Antitrust Questions*

The fixing of minimum commission rates by agreement among the members of an exchange would clearly violate section 1 of the Sherman Act as an agreement among competitors to restrain price competition, unless an exemption is available. In *Silver v. New York Stock Exchange*,[90] decided in 1963, the Supreme Court held that

> The Securities Exchange Act contains no express exemption from the antitrust laws . . . . This means that any repealer of the

[88] *Proposed*, SEC Securities Exchange Act Release No. 8242 (Feb. 1, 1968); *adopted*, SEC Securities Exchange Act Release No. 8347 (June 28, 1968).

[89] *Id.*

[90] 373 U.S. 341 (1963).

> antitrust laws must be discerned as a matter of implication, and "[i]t is a cardinal principle of construction that repeals by implication are not favored." . . . Repeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary.[91]

The *Silver* case did not involve the NYSE's power to adopt rules fixing minimum rates of commissions, but rather its action in instructing its members to discontinue their wire connections with the plaintiff, a non-member firm.

In *Kaplan v. Lehman Brothers*[92] shareholders in five mutual funds sued the NYSE and four of its member firms, which had acted as brokers for the funds, to recover treble damages based on the difference between the commissions charged to the funds under the NYSE rules and the rates that would have been available to the funds "by the operation of free and open competition."[93] Plaintiffs took the position that prescribed minimum rates can never be reasonable and that the fixing of minimum rates through the collective action of NYSE members is therefore illegal per se under the Sherman Act.[94] On the issue of per se illegality, the district court held that if the NYSE action was within the authority conferred on the Exchange by the 1934 Act, plaintiffs' position was inconsistent with the *Silver* decision. The court entered summary judgment for defendants. On appeal to the Seventh Circuit, the SEC filed an amicus curiae brief[95] that urged three points: (*1*) "Collective action by the Exchange and its members in establishing commission rate rules is specifically contemplated under the Securities Exchange Act and thus does not constitute a per se violation of the antitrust laws;"[96] (*2*) the possible unreasonableness of existing minimum commission rates should not give rise to a cause of action under the antitrust laws;[97] and (*3*) an exchange should be exempt from antitrust liability when

> (1) the allegedly illegal conduct is strictly pursuant to an exchange rule promulgated in the course of self-regulatory duties and consistent with traditional concepts of fair and orderly procedures; (2) the exchange rule was filed with Commission; (3) the particular

91 *Id.* at 357.

92 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir.), *cert. denied*, 389 U.S. 954 (1967).

93 250 F. Supp. at 563.

94 *Id.* at 564.

95 Brief for Securities & Exchange Commission as Amicus Curiae, Kaplan v. Lehman Bros., 371 F.2d 409 (7th Cir. 1967).

96 *Id.* at 11.

97 *Id.* at 20.

> rule in question was subject to the Commission's oversight and authority under Section 19(b) or other sections of the Exchange Act, and within the area in which Congress contemplated that the exchanges would act, unless and until otherwise determined by the Commission; and (4) the rule is applied in a fundamentally fair manner consistent with the purposes and goals of the Exchange Act.[98]

The court of appeals affirmed in a two-page opinion which went beyond the position taken by either the district court or the SEC. It "interpreted" the district court's action "as holding that the antitrust laws are inapplicable to the New York Stock Exchange insofar as its prescribing of minimum commission rates is concerned," and held that

> [o]n the facts set forth in the complaint herein, we do not construe the Sherman act and the exchange act as showing a congressional intention to permit the maintenance of an antitrust prosecution of the exchange or its members to be based upon its action relating to rates of commission to be charged by its members.[99]

The Supreme Court denied certiorari, over the dissent of Chief Justice Warren who argued that the "blunderbuss approach" of the Seventh Circuit "falls far short of the close analysis and delicate weighing process mandated by this Court's opinion in *Silver*."[100]

On July 1, 1968, the SEC commenced a public hearing into the commission rate structure of the national securities exchanges.[101] The memorandum that the NYSE submitted in August 1968[102] argues, on the basis of legislative history, not only that the antitrust laws are inapplicable to the fixing of minimum commission rates by exchanges, but that the SEC has no power under the Exchange Act "to prevent the exchanges from fixing commission rates or to abolish exchange rules which do so."[103] The NYSE further contends that elimination

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98 *Id.* at 32-33 (footnote omitted).

99 371 F.2d at 411. *Cf.* Thill Securities Corp. v. New York Stock Exchange, 38 U.S.L.W. 2138 (E.D. Wis. Aug. 21, 1969), where the court held that the NYSE prohibition against members sharing commissions with non-members did not constitute a per se violation of the antitrust laws and that it would be inappropriate for the court to inquire into the reasonableness of the prohibition in light of the SEC's current hearings on stock exchange commission rates.

100 389 U.S. 951, 957 (1967) (dissenting opinion). Neither the SEC nor the Justice Department took a position on the granting of certiorari.

101 *See* SEC Securities Exchange Act Release No. 8324 (May 28, 1968).

102 Memorandum on Behalf of the New York Stock Exchange on Commission Rate Structure of Registered National Securities Exchanges, August 1968.

103 *Id.* at 7. *But see* SEC Securities Exchange Act Release No. 8324 (May 28, 1968), requesting the NYSE, pursuant to § 19(b) of the Exchange Act, either to adopt specified revised minimum commission rates or to eliminate minimum rates with respect to orders

of fixed minimum commissions would "undermine" the regulatory role of exchanges,[104] "result in destructive competition,"[105] and "result in rate discriminations, unrelated to volume discounts or cost savings, in favor of large investors."[106]

The Justice Department responded in January 1969 with a 200-page memorandum.[107] It contends that "the system of fixed minimum commissions is not justified or needed 'to make the Securities Exchange Act work,' "[108] and that the "historical context is utterly inconsistent with any inference that Congress intended to ratify the then existing rate structure or other practices."[109] The memorandum concludes that the SEC "has the duty to effect the reconciliation of the antitrust laws and the Securities Exchange Act outlined in the *Silver* case," and "has the power, and indeed the duty, to abolish commission rate fixing on registered national securities exchanges except to the extent that it can be shown that such price fixing is necessary to achieve the purposes of the Act."[110] The Justice Department also argues that elimination of fixed minimum commission rates would "strengthen the NYSE mar-

above $50,000. In its reply, the NYSE indicated that it considered both alternatives, but felt that it was in the public interest to maintain minimum rates of commission. Letter from NYSE to SEC, Aug. 8, 1968.

104 NYSE Memorandum, *supra* note 102, at 18.

105 *Id.* at 20.

106 *Id.* at 24.

107 Justice Dep't Memo, *supra* note 57.

108 *Id.* at 13.

109 *Id.* at 21.

110 *Id.* at 18. *See* FMC v. Aktiebolaget Svenska Amerika Linien, 390 U.S. 238 (1968), involving shipping conference rules that prohibited travel agents from selling passage across the Atlantic on non-conference lines and required unanimous action by conference members before the maximum commission rates payable to travel agents could be changed. The Federal Maritime Commission, in disapproving the agreements as "contrary to the public interest," stated that "conference restraints that interfere with the policies of antitrust laws will be approved only if . . . necessary to secure important public benefits or in furtherance of a valid regulatory purpose of the Shipping Act." It placed the burden of proof on the steamship lines to establish these legitimate objectives and justify the restraints. The steamship lines argued that the FMC antitrust test was not a permissible elaboration of the "public interest" standard since "the whole purpose of the statutory scheme would be defeated if incompatibility with the antitrust laws can be a sufficient reason for denying immunity from these laws." The Supreme Court unanimously affirmed the FMC's decision, holding that

> once an antitrust violation is established, this alone will normally constitute substantial evidence that the agreement is "contrary to the public interest," unless other evidence in the record fairly detracts from the weight of this factor. . . . [Thus] the antitrust test formulated by the Commission is an appropriate refinement of the statutory "public interest" standard.

Id. at 245-46. *See* Note, *Antitrust and the Securities Industry: Lessons from the Shipping Industry*, 55 CORNELL L. REV. 96 (1969).

ket,"[111] and recommends that the SEC eliminate fixed minimum commission rates over a five-year period, commencing with the elimination of fixed minimums on transactions over $50,000 and reducing that figure by $10,000 each year.[112]

III

Over-the-Counter Transactions

In contrast to stock exchange transactions, no minimum commission rates are applicable to transactions in the over-the-counter (OTC) market. The Exchange Act specifically provides that a national securities association, such as the NASD, may not adopt rules designed "to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." On the other hand, the rules of such an association must be designed "to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges."[113]

The rules governing compensation for transactions in the OTC market are complicated by the broker-dealer's ability, in many transactions, to choose whether to act as agent or principal. If the broker-dealer maintains an inventory in the particular security, he will normally sell to his customer from that inventory as principal. If he must obtain the security from another dealer, he may either buy for his customer as agent and charge a commission or buy as principal and resell to the customer at a mark-up.

An SEC sampling of sales of 135 OTC stocks on January 18, 1962, showed that in fifty percent of the retail sales transactions the broker-dealers purchased for customers as agents, in twenty-five percent they purchased and resold as principal, and in twenty-five percent they sold as principal from inventory.[114] An NASD sampling of 246 stocks sold on August 11, 1965, showed that in sixty-six percent of such transactions the broker-dealers purchased for customers as agents, in twelve

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111 Justice Dep't Memo 43.

112 *Id.* at 195, 196. The present Assistant Attorney General, Richard W. MacLaren, has taken a similar position, stating that "[t]he question is whether rate fixing and related practices are necessary . . . to achieve a legitimate goal of the Exchange Act. . . . If they are not necessary, then they are subject to the Sherman Act, just like any other agreement in restraint of trade." BNA Sec. Reg. & L. Rep. No. 5, at A-2 (July 2, 1969).

113 Securities Exchange Act of 1934, § 15A(b)(8), 15 U.S.C. § 78o-3(b)(8) (1964).

114 OTC Study 15.

percent they purchased and resold as principal, and in twenty-two percent they sold as principal from inventory.[115]

A. *Compensation for Acting as Customer's Agent*

When a broker-dealer buys or sells a security for a customer as agent, the NASD requires that

> he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.[116]

The amount of the commission must be set forth on the confirmation that the broker-dealer is required to send the customer on completion of the transaction.[117]

Although stock exchange commission rate schedules are inapplicable to OTC stock transactions, including transactions handled by member firms, the *Special Study* found that approximately ninety-five percent of the agency transactions in OTC stocks in its 1962 sample were executed at the NYSE commission rate, and that non-member as well as member firms tended to use the NYSE schedule in such transactions.[118] A study of agency transactions done for the NASD showed that the average charge on a purchase or sale for a customer in September 1965 was 1.10 percent of the money involved in the transaction.[119]

B. *Compensation for Dealing with Customer as Principal*

In contrast to the situation where a broker-dealer acts as agent for his customer, a broker-dealer who acts as a principal in the sale of a security to his customer is not required to disclose on the confirmation anything other than the "net" price to be paid by the customer for the security.[120] Without information as to the cost of the security to the dealer or the prices currently being quoted by dealers

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115 *Id.* The reasons for the increase in agency transactions as against non-inventory principal transactions are discussed in text accompanying notes 147-160 *infra.*

116 NASD Rules, art. III, § 4.

117 Securities Exchange Act of 1934, § 15(c)(1); rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1969).

118 SPECIAL STUDY, pt. 2, at 624, 625.

119 OTC STUDY 34.

120 *See* Securities Exchange Act of 1934, § 15(c)(1); rule 15c1-5.

making a market in the stock, the customer has no way of knowing what he is being charged for the dealer's services.[121]

1. *Limitations on Mark-Ups*

In 1942 the SEC published for comment a rule that would have required dealers to disclose to their customers in principal transactions the best current independent bid and asked prices for the security. The NASD opposed this proposal, and surveyed its members to determine their mark-up practices. It ascertained that forty-seven percent of the transactions were made at mark-ups of three percent or less and seventy-one percent were made at mark-ups of five percent or less.[122] In October 1943 the NASD distributed the results of the survey to its members, noting that there might be circumstances in which a mark-up of more than five percent would be justified, and that a mark-up of five percent or even lower is not always justified, but the five percent figure would serve as a guide to what constitutes a "fair spread or profit" within the meaning of the NASD's Rules of Fair Practice.[123]

This "five percent policy" has been elaborated through interpretation over the years. The amount of the mark-up is to be computed by reference to the "prevailing market price," of which the dealer's contemporaneous cost is the best indication in the absence of other bona fide evidence.[124] A mark-up pattern of five percent or even less may be considered unfair or unreasonable under appropriate circumstances. The fairness of mark-ups may not be justified on the basis of excessive expenses, but should be determined by reference to all relevant factors, including the type and price of the security and its availability in the market, the amount of money involved in the transaction, the nature of the dealer's business, the type of service and facilities provided to customers, the dealer's general pattern of mark-ups, and the type and extent of disclosure he makes to his customers.[125]

A large number of disciplinary proceedings based wholly or partly on excessive mark-ups have been brought against broker-dealers by both the NASD and the SEC. Both the NASD and the SEC require

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121 *See* Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943).

122 NASD Rules, Interpretation of the Board of Governors following article III, § 4.

123 *Id.* In 1944, members of the NASD challenged the Board's authority to establish the "5% policy" by interpretation of the Rules of Fair Practice and demanded that the policy statement be considered a rule which must be submitted to a membership vote. The SEC held that the Board's action was "by no means an inflexible limitation on spreads," and thus constituted an interpretation rather than a rule. NASD, Inc., 17 S.E.C. 459 (1944).

124 NASD Rules, Interpretation of the Board of Governors following article III, § 4.

125 *Id.*

that retail sales and purchase prices be reasonably related to the "current" or "prevailing" market price at the time of the challenged transactions.[126] Usually proceedings are initiated against brokers whose mark-ups are consistently not reasonably related to current market price. Objectionable patterns have consisted of as many as 563[127] and as few as fourteen[128] transactions, and mark-ups found unfair have ranged from 5.4 percent[129] to 200 percent.[130] Although the decisions generally refer to the NASD's "five percent policy," mark-ups between five percent and ten percent may be justified in some instances. Mark-ups above ten percent are generally considered unjustifiable.[131] In cases that also involve other improper practices, a violation of the mark-up rule may be found on the basis of fewer transactions and lower mark-ups.[132]

When the NASD has shown the existence of a pattern of mark-up violations, the member has the burden of establishing "justifying circumstances" for his action.[133] The following have been held not to be "justifying circumstances": excessive expenses in making a sale;[134] risk in maintaining a large inventory;[135] small total dollar amount of the transaction;[136] reliance on NASD inspection and approval of books;[137] and mark-ups consistent with those customary in the vicinity.[138] In

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126 Thill Securities Corp., SEC Securities Exchange Act Release No. 7342, at 6 (June 11, 1964).

127 J.A. Winston & Co., SEC Securities Exchange Act Release No. 7334 (June 5, 1964).

128 Powell & McGowan, Inc., SEC Securities Exchange Act Release No. 7302 (April 24, 1964).

129 *Id.*

130 Linder, Bilotti & Co., Inc., SEC Securities Exchange Act Release No. 7738 (Nov. 5, 1965).

131 Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003, at 4 (Dec. 8, 1966). The SEC has "repeatedly held that mark-ups of more than 10% are unfair even in the sale of low priced securities and particularly where there are transactions of substantial size." Costello, Russotto & Co., SEC Securities Exchange Act Release No. 7729, at 5 (Oct. 22, 1965).

132 Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965); Powell & McGowan, Inc., SEC Securities Exchange Act Release No. 7302 (April 24, 1964).

133 NASD Rules, Interpretation of the Board of Governors following article III, § 4.

134 Kenneth B. Stucker Investment Securities, SEC Securities Exchange Act Release No. 7823 (Feb. 15, 1966).

135 General Investing Corp., SEC Securities Exchange Act Release No. 7316 (May 15, 1964).

136 Amsbary, Allen & Morton, Inc., SEC Securities Exchange Act Release No. 7834 (March 7, 1966).

137 Midland Securities, Inc., 40 S.E.C. 333 (1960).

138 Amsbary, Allen & Morton, Inc., SEC Securities Exchange Act Release No. 7834 (March 7, 1966).

many instances, the dealer claims his mark-up was justified because the sale was of a low-priced security, relying on an NASD statement that a "somewhat higher percentage may sometimes be justified" in the case of a low-priced security; *i.e.*, a security that sells for ten dollars or less.[139] It seems, however, that the "low price factor" alone will not justify a consistent pattern of mark-ups at a level substantially above five percent.[140]

a. *Determination of Prevailing Market Price*. A retail dealer who does not maintain a position in a particular security should, in the absence of countervailing evidence, use his contemporaneous cost—the price paid to other dealers to purchase the same security on the same day—as his mark-up base.[141]

When a dealer who makes a wholesale market in a security sells that security to a retail customer out of inventory, there is a question whether the mark-up should be based on the dealer's contemporaneous cost, normally his *bid* price, or the price at which the stock is then being *offered* by dealers to one another. The *Special Study* found that most integrated firms base their mark-up on the price at which they are then offering the stock to other dealers[142] and recommended that the obligations of an integrated broker-dealer in respect to his retail pricing be "defined . . . more clearly and positively."[143] The 1966 *OTC Study*[144] computed gross income from retail OTC sales as "the difference between the then current interdealer *asked* price and the 'net' price confirmed to the customer."[145]

Recent cases indicate that an integrated dealer is required to use his contemporaneous cost as a mark-up base when the security is not actively traded among dealers, that is, when no independent competi-

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139 Handley Invest. Co. v. SEC, 354 F.2d 64, 65 (10th Cir. 1965) (quotes interpretation of NASD Rules art. III, §§ 1, 4, which refer to securities worth less than $10); Samuel B. Franklin & Co. v. SEC, 290 F.2d 719, 725 (9th Cir. 1961) (court refers to the same quote); Ross Securities Inc., 40 S.E.C. 1064, 1066 (1962).

140 *See* Handley Invest. Co. v. SEC, 354 F.2d 64 (10th Cir. 1965) (25%-57% mark-up on 6¾-8½ cent stocks held excessive); Managed Investment Programs, 37 S.E.C. 783 (1957) (10%-21% mark-up on $2 and $3 stocks held excessive); Amsbary, Allen & Morton, Inc., SEC Securities Exchange Act Release No. 7834 (March 7, 1966) (8.3%-11% on 26 transactions at prices from $5.75-$6.50 held excessive).

141 *See* Kenneth B. Stucker Investment Securities, SEC Securities Exchange Act Release No. 7823 (Feb. 15, 1966); Costello, Russotto & Co., SEC Securities Exchange Act Release No. 7729, at 2 (Oct. 22, 1965); J.A. Winston & Co., SEC Securities Exchange Act Release No. 7337 (June 8, 1964).

142 SPECIAL STUDY, pt. 2, at 649.

143 *Id.* at 677.

144 *See* note 1 *supra*.

145 OTC STUDY, Appendix C, form III.

tive market exists. This is usually the case where the integrated firm is the dominant factor in either the wholesale or retail market. When an independent competitive retail and wholesale market does exist, the integrated dealer may use the offering prices quoted by other dealers to one another as the basis for his retail mark-ups.[146]

2. *Special Study Recommendations*

Among the sixteen recommendations of the *Special Study* concerning OTC markets, three recommendations relating to dealers' charges for retail transactions were subjects of particular objection by segments of the securities business.[147]

a. *"Riskless" Transactions.* The *Special Study* recommended that "a broker-dealer who neither is a primary market maker nor has a bona fide inventory position should be required (subject to defined exceptions) to execute customers' orders on an agency basis."[148] This proposal was designed to require disclosure of the amount of the retail mark-up in the so-called "riskless transaction" whereby a broker-dealer, after accepting a customer's order, purchases the stock from another dealer as principal and resells at a mark-up to the customer.

In discussions with the SEC in 1964, the NASD argued that this proposal would tend to force firms to execute OTC transactions at commissions roughly equivalent to NYSE minimum commission rates, thus putting an "economic squeeze" on its members and diverting their merchandising efforts away from OTC stocks.[149] The SEC has taken no action to implement the recommendation. The 1966 *OTC Study* showed, however, that the average mark-up on "riskless" principal transactions declined from 2.93 percent in September 1963 to 2.40 percent in September 1965, while, in comparison, average commissions on agency transactions only declined from 1.13 percent to 1.10 percent during the same period.[150] Furthermore, between 1962 and 1965 the proportion of retail OTC sales accounted for by "riskless" principal transactions declined from about twenty-five percent to about twelve percent, while the proportion accounted for by agency transactions in-

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146 Langley-Howard, Inc., SEC Securities Exchange Act Release No. 8361 (July 21, 1968); Century Securities Co., SEC Securities Exchange Act Release No. 8123 (July 14, 1967); Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003 (Dec. 8, 1966); Strathmore Securities, Inc., SEC Securities Exchange Act Release No. 7864 (April 18, 1966); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965).

147 OTC STUDY 1.

148 SPECIAL STUDY, pt. 2, at 676.

149 OTC STUDY 2.

150 *Id.* at 34.

creased from about fifty percent to sixty-six percent.[151] These changes are attributable in part to the improvements in disclosure discussed below.[152]

b. *Disclosure.* The *Special Study* recommended changes in the manner in which "retail" quotations were furnished either by or under the supervision of the NASD for publication in newspapers.[153] While the bid prices published at that time generally represented the inter-dealer bids, the retail asked prices were generally determined by adding to the inter-dealer asked prices a percentage mark-up ranging from about five percent on stocks selling below twenty-five dollars to about two percent on stocks selling above $135.[154] The *Special Study* concluded that this system must be "confusing if not deceptive to many investors"[155] since an investor "may get the impression or actually be told that his security was bought commission free, below the 'high.' "[156] It recommended that the newspaper quotations be revised "to show generally . . . the best prevailing interdealer bid and asked quotations that can be reasonably ascertained."[157]

In 1964 the NASD, with the concurrence of the SEC, adopted a plan providing for newspaper publication of representative inter-dealer bid and asked prices for the approximately 1,300 actively traded stocks of larger companies that appear on the "national list." This system was inaugurated "on a test basis" in February 1965, and has been in effect since that time. In 1966 it was extended to the less actively traded securities of smaller companies appearing on the so-called "local lists."[158]

A third controversial recommendation by the *Special Study* was that a broker-dealer selling as principal be required to state in the confirmation the inter-dealer price available at the time of the transaction, thereby showing the customer the approximate amount of the mark-up.[159] The NASD strongly opposed this recommendation on economic grounds,[160] and it has not been implemented.

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151 *Id.* at 15.

152 *Id.*

153 SPECIAL STUDY, pt. 2, at 677.

154 *Id.* at 634.

155 *Id.* at 667.

156 *Id.* at 644 (footnote omitted).

157 *Id.* at 677.

158 NASD, 1966 ANN. REP. 4.

159 SPECIAL STUDY, pt. 2, at 677, 678.

160 OTC STUDY 2.

IV

Sale of Mutual Fund Shares

A. *Method of Fixing Sales Loads*

In contrast to stock exchange transactions, for which uniform minimum commissions are established by the various exchanges, and to OTC transactions, to which no minimum commissions or mark-ups are applicable, the compensation payable to a dealer for selling shares of a mutual fund is fixed by the sponsor of each fund and is binding on all dealers who sell shares of that fund.

Under section 22(d) of the Investment Company Act of 1940, no dealer may sell shares of a mutual fund to a public customer "except at a current public offering price described in the prospectus." This restriction is applicable regardless of whether the dealer acquired the shares from the fund itself or from a shareholder of the fund.[161] The fund prospectus normally sets forth the public offering price of fund shares in terms of the net asset value of the fund on a per-share basis plus a sales load, which is a specified percentage of the public offering price.[162] For example, if a mutual fund prospectus specifies a sales load of 8.5 percent of the public offering price, and the current net asset value of the fund works out to $9.15 per share, a customer who buys one hundred shares of the fund will pay $1,000, of which $85 (8.5 percent of the *public offering price*) is divided between the dealer and the principal underwriter and $915 is paid over to the fund to purchase the one hundred shares.

B. *Level of Sales Loads*

In its 1966 *Mutual Fund Report*, the SEC found that the prevailing level of sales loads was 8.5 percent of the public offering price.[163]

161 This restriction was a factor in the virtual elimination of secondary trading in mutual fund shares.

162 Rule 22c-1, which became effective January 13, 1969, provides that the price at which mutual fund shares are sold must be based on the first net asset value computed *after* the order is received by the dealer. This procedure is known as "forward pricing." The net asset value must be recomputed at least once a day. Prior to January 13, 1969, many funds sold shares on the basis of the last net asset value computed *before* a specified cut-off time which preceded the receipt of the order. Rule 22c-1: *proposed*, SEC Investment Company Act Release No. 5413 (June 25, 1968); *adopted*, SEC Investment Company Act Release No. 5519 (Oct. 16, 1968); *interpreted*, SEC Investment Company Act Release No. 5569 (Dec. 27, 1968).

163 SEC, Public Policy Implications of Investment Company Growth, *published as*

Of the 195 load funds listed in one compilation, none charged more than nine percent, 102 charged exactly 8.5 percent, and only eight charged less than 7.5 percent.[164] The Commission also found that competitive pressures had resulted in an increase in sales loads over the years, since funds compete for the favor of dealers by offering higher compensation rather than for the favor of customers by offering lower sales costs.[165] A survey of thirty leading load funds indicated that the median sales load had increased from 7.5 percent in 1950 to 8.5 percent in 1966.[166]

There is no general statutory limit on mutual fund sales charges. Section 27(a)(1) of the Investment Company Act, however, limits the sales load on periodic payment plans to nine percent,[167] and there have been some indications that the SEC might take the view that a sales load in excess of nine percent on shares of any mutual fund is "unconscionable or grossly excessive."[168]

Section 22(b) of the Investment Company Act authorizes the NASD to adopt rules limiting the discount from the public offering price at which its members may purchase mutual fund shares "in order that the price at which such security is offered or sold to the public shall not include an unconscionable or grossly excessive sales load."[169] Pursuant to this provision, the NASD has adopted a rule prohibiting any member from participating in the offering or sale of mutual fund shares for which they act as underwriter, if the offering price includes a sales load "which is unfair, taking into consideration all relevant circumstances, including the current marketability of such security and all expenses involved."[170]

However, the NASD has specifically made its "five percent policy" on mark-ups for OTC securities inapplicable to the distribution of mutual fund shares on the ground that such transactions are "underwriting" activities.[171] This rationale is questionable; distribution of mutual fund shares is technically an "underwriting" activity in the sense of a public offering of newly issued securities, but it is com-

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H.R. REP. No. 2337, 89th Cong., 2d Sess. 19 (1966) [hereinafter cited as MUTUAL FUND REPORT].

164 *Id.* at 204.

165 *Id.* at 208.

166 *Id.*

167 *See* text accompanying notes 193-94 *infra.*

168 *Hearings on H.R. 9510 & 9511 Before the Subcomm. of the House Comm. on Interstate and Foreign Comm.*, 90th Cong., 1st Sess. 722 (1967).

169 15 U.S.C. § 80a-22(b) (1964).

170 NASD Rules, art. III, § 26(d).

171 NASD Rules, Interpretation of the Board of Governors following article III, § 4.

pletely "riskless" since NASD rules prohibit members from purchasing any shares of a mutual fund except for the purpose of filling an order already received from a customer.[172]

In its 1966 *Mutual Fund Report*, the SEC recommended that the Investment Company Act be amended to provide that sales charges for mutual fund shares be limited to five percent of the net asset value (equivalent to 4.76 percent of the public offering price).[173] This proposal was strongly opposed by the industry, and the Senate Banking and Currency Committee rejected it during the 1967 hearings on mutual fund legislation. The Committee instead recommended an amendment of section 22(b) to authorize the NASD (or any other securities association registered under section 15A of the Exchange Act) to prohibit its members from offering mutual fund shares at a price that includes an "excessive" sales load.[174] This provision was carried over into the 1969 Senate bill.[175] In formulating rules as to excessive sales loads, the association would be required by the bill to "allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors."[176]

Eighteen months after enactment of the proposed amendments, the SEC would be authorized to alter or supplement the rules of the association as necessary to effectuate the purpose of the amendments.[177] This authority would be exercised in the manner prescribed in section 15A(k)(2) of the Exchange Act, under which the SEC must first request the association to alter or supplement its rules in a specified manner. If such action is not taken within a reasonable time, the SEC itself, after appropriate notice and opportunity for hearing, may order the rules of the association to be altered or supplemented as necessary to effectuate the statutory objectives.[178]

The SEC would also be authorized, after eighteen months, to adopt rules effectuating the purpose of the amendments by regulating sales by broker-dealers who are not members of a registered securities

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[172] NASD Rules, art. III, § 26(f)(2).

[173] MUTUAL FUND REPORT 223.

[174] S. REP. No. 1351, 90th Cong., 2d Sess. 2, 15 (1968) [hereinafter cited as *1968 Senate Report*]. At present such an association can prohibit only sales at prices that include "unconscionable or grossly excessive" sales loads. Investment Company Act of 1940, § 22(b), 15 U.S.C. § 80a-22(b) (1964).

[175] S. 2224, 91st Cong., 1st Sess. § 12 (1969). The Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce held hearings on the Senate bill in late 1969. This provision of the bill is not opposed by the industry.

[176] *Id.*

[177] *Id.*

[178] *Cf.* note 74 *supra* and accompanying text.

association.[179] However, a non-member broker-dealer would not be subject to regulation if the underwriter of the mutual fund shares which he is selling filed a notice of election to comply with the rules of the association in distributing the shares of such fund.[180]

C. *Quantity Discounts*

The public offering price set forth in a mutual fund prospectus customarily provides for progressively lower sales loads on larger purchases. The first breakpoint is usually between $10,000 and $25,000; above it the sales load is about one percent lower. There are usually further step-downs leading ultimately to a load of about one percent on sales exceeding $1,000,000.[181] Many funds permit a series of purchases, or purchases of shares of different funds distributed by the same principal underwriter, to be cumulated for purposes of entitling the purchaser to the lower sales load.[182]

In 1941 the SEC's General Counsel gave an opinion that the quantity discount practice did not violate section 22(d), which requires that mutual fund shares be sold at "a current public offering price described in the prospectus," if the quantity discounts were clearly described in the prospectus and available to any member of the public on a nondiscriminatory basis.[183] In 1958 the SEC codified this opinion in rule 22d-1,[184] which provides an exemption from section 22(d) to the extent necessary to permit sales at reduced sales loads "in accordance with a scale of reducing sales load varying with the quantity of securities purchased by any person." The rule provides that the reduced sales load may be applied to the purchase of shares of several funds distributed by the same principal underwriter. The reduction may be applied on the basis of the amount involved in (*1*) a single purchase, (*2*) a single purchase plus amounts previously purchased, or (*3*) a series of purchases over a period of not less than thirteen months pursuant to a "statement of intention" containing certain specified provisions.

In a recent case based on the contention that mutual fund quantity

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179 Several large mutual fund underwriters distribute their shares through "captive" sales organizations which are not members of the NASD.

180 S. 2224, 91st Cong., 1st Sess. § 12 (1969).

181 MUTUAL FUND REPORT 210. Inducing a customer to purchase an amount of shares just below an amount that would entitle him to a lower sales load has been held by the NASD to be contrary to just and equitable principles of trade. NASD MANUAL, Interpretation of Board of Governors ¶ 5266. *See* Mason, Moran & Co., 35 S.E.C. 84 (1953); SEC Securities Exchange Act Release No. 7743, at 34 (Nov. 12, 1965); Russell L. Irish Investments, SEC Securities Exchange Act Release No. 7687, at 7 (Aug. 27, 1965).

182 MUTUAL FUND REPORT 206, 207.

183 Opinion of General Counsel, SEC Investment Company Act Release No. 89 (March 13, 1941); 2 P-H SEC. REG. ¶ 26,324.1, at 25,656.

184 SEC Investment Company Act Release No. 2798, at 47 (Dec. 2, 1958).

discounts violate the price discrimination provisions of the Robinson-Patman Act,[185] the court concluded that

> [T]he Act was enacted to protect only persons in a competitive relationship with one another, and personal investors do not occupy that status. The alleged "price discrimination" would be immune from attack . . . because cumulative quantity discounts are impliedly exempted from the Robinson-Patman Act by virtue of the Investment Company Act of 1940 and the rules and regulations of the SEC enacted pursuant to it.[186]

1. *Group Sales*

Prior to 1958, the SEC allowed medical and dental associations and other groups to pool payments by their members and to purchase mutual fund shares at the lower sales loads applicable to large purchases.[187] In 1958, in response to "industry complaints" that the practice of group sales threatened the industry's "orderly distribution system,"[188] the SEC provided in rule 22d-1 that quantity discounts should not be available to "a group of individuals whose funds are combined, directly or indirectly, for the purchase [of fund shares or] a trustee, agent, custodian, or other representative of such a group."[189] The SEC justified its position on the ground that group sales are inconsistent with the policy against "discriminatory pricing policies" found in section 22(d), even though in rule 22d-1 it specifically sanctioned discounts for large purchases by single individuals for their own account and sales at a reduced load or no load to officers, directors, partners, and employees of the funds.[190]

In October 1968 the SEC announced that it was considering amending rule 22d-1 to delete the clause prohibiting quantity discounts for group purchases. It stated that, as a result of its studies of the mutual fund industry, it "now believes that no disruption of the or-

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185 15 U.S.C. § 13(a) (1964).

186 Baum v. Investors Diversified Services, Inc., 286 F. Supp. 914, 921 (N.D. Ill. 1968).

187 SEC Investment Company Act Release No. 2798, at 46 (Dec. 2, 1958).

188 *Id.* at 45.

189 This was done by adopting a special definition of "person" for the purpose of rule 22d-1. "Person," as defined by §§ 2(a)(27) and 2(a)(8) of the Investment Company Act includes "any organized group of persons whether incorporated or not." In 1960 the SEC also ruled that groups which had been taking advantage of the quantity discount prior to the SEC's change of heart could not continue to do so on future purchases. SEC Investment Company Act Release No. 3015 (April 15, 1960).

190 *See In re* Travelers Equities Fund, Inc., BNA SEC. REG. & LAW REP. No. 19, at A-5 (Oct. 8, 1969) in which the NASD opposed a proposal by Travelers to offer shares without any sales load to employees of all Travelers companies as well as to contract sales representatives and their employees. Travelers subsequently limited its requested exemption and the NASD withdrew its opposition. *See* BNA SEC. REG. & LAW REP. No. 23, at A-15 (Nov. 5, 1969).

derly, effective distribution system of mutual funds shares would develop if mutual funds and their distributors were allowed, on a strictly voluntary basis, to afford quantity discounts to groups of individuals . . . on a uniform, nondiscriminatory basis."[191] Industry spokesmen have opposed the amendment,[192] and the SEC has as yet taken no further action.

D. *Periodic Payment Plans*

Special provisions are applicable to periodic payment plans (also known as "contractual plans" or "front-end load plans"). Under these plans, mutual fund shares are purchased by payment of monthly or other periodic fixed installments over a period of years. A distinctive feature of the plans is that, while the payments are generally spread over a period of ten years or more, a large part of the sales load on the total plan is deducted from the payments made during the first year.

Under section 27(a) of the Investment Company Act, the total sales load on the completed plan may not exceed nine percent of the total payments made by the purchaser, but up to one-half of each of the first twelve monthly payments may be deducted for sales load.[193] For example, a plan calling for payment of $12,000 in 120 monthly installments of $100 each can provide for a total sales load of $1,080, obtained by deducting $50 from each of the first twelve payments and $4.44 from each of the remaining 108 payments.[194]

In its 1966 *Mutual Fund Report,* the SEC recommended that front-end loads in the sale of mutual fund shares be prohibited and that the sales load be required to be uniform on all installments.[195] This recommendation was based on the finding that the substantial proportion of investors who signed up for these plans and who were unable or unwilling to continue making payments were penalized by sales charges that could run as high as fifty percent of the amount they had invested.[196]

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191 SEC Investment Company Act Release No. 5507, at 2 (Oct. 7, 1968).

192 *See* Simpson & Hodes, *The Continuing Controversy Surrounding the Uniform Price Maintenance Provisions of the Investment Company Act of 1940*, 44 NOTRE DAME LAW. 718, 724 (1969). While a majority of the comments opposed any discounts on group sales, a number of commentators indicated that they would approve the proposal if it could be limited to bona fide groups formed for unrelated purposes, and if other procedural problems could be resolved.

193 MUTUAL FUND REPORT 230.

194 The sale of periodic payment plans featuring a front-end load is prohibited or sharply limited in California, Illinois, and Wisconsin. CAL. ADMIN. CODE tit. 10, § 260.140.80; ILL. SEC. L. REGS., rule c-9; WISC. ADM. CODE, SEC 2.03.

195 MUTUAL FUND REPORT 247.

196 *Id.* at 22, 237.

The prohibition of front-end load plans was vigorously opposed by the Association of Mutual Fund Plan Sponsors, a trade association.[197] The mutual fund bill passed by the Senate in 1968 substituted a provision that preserved the nine percent sales load limit for the entire plan but provided that not more than twenty percent of any payment could be deducted for sales load. The bill also limited the average deduction for sales load on the first forty-eight monthly payments to sixteen percent.[198] The purpose of this provision was to permit the dealer to receive as much compensation on the first forty-eight monthly installments as he can receive under the present law, but to spread that compensation more evenly over the forty-eight-month period so that, no matter how early an investor dropped out of the plan, he could not be penalized by an effective sales load of greater than twenty percent.

The 1968 Senate bill also provided that when, in any month, an investor paid more than the minimum monthly payment called for by the plan, the sales load on the excess would be at the lower rate applicable to payments made after the first forty-eight monthly payments.[199] This provision was designed to deal with the situation in which, for example, a customer buying a fifty-dollar-a-month plan is induced to start with a lump-sum payment of $600—equivalent to the entire first year's payments—on which the sales load would currently be $300. The Senate committee felt that the practice of charging the higher load on lump-sum payments is "totally inconsistent with the industry's justification of the front-end load—that it is necessary to provide adequate compensation for the sale of mutual fund shares to people who are only able to invest small amounts of money at a given time."[200]

The bill passed by the Senate in 1969 retains the pattern of limitations found in the 1968 bill, but applies them only to plan sponsors who elect to be governed by them.[201] Non-electing plan sponsors would continue to be governed by the present limitations of section 27(a), subject to the proviso that if any investor redeemed his plan within three years from the time of his first payment, he would be entitled to receive (*1*) the value of his account under the plan, which would reflect any gain or loss in the net asset value of the underlying fund shares, plus (2) the amount by which the aggregate sales load he had paid

197 *Hearings on S. 1659 Before the Senate Comm. on Banking & Currency*, 90th Cong., 1st Sess. 372 (1967).

198 S. 3724, 90th Cong., 2d Sess. § 16 (1968). *See also 1968 Senate Report* 16.

199 S. 3724, 90th Cong., 2d Sess. § 16 (1968).

200 *1968 Senate Report* 17.

201 S. 2224, 91st Cong., 1st Sess. § 17(f) (1969).

exceeded fifteen percent of his total payments made under the plan.[202] The plan sponsor would be required to notify any investor who had missed three payments or more during the first three years of the plan of his right to redeem and the amounts to which he would be entitled under this provision.[203]

The 1969 bill also provides that, within sixty days after any person invests in a plan, he must be sent a notice setting forth the charges to be deducted from his payments under the plan and notifying him that he has a right to withdraw from the plan within sixty days of the mailing of the notice and to receive (*1*) the value of his account, plus (*2*) the sales loads, custodian fees, and other expenses with which he has been charged.[204] While the Senate Committee Report is unclear on the point,[205] it appears that this right of withdrawal applies whether the plan sponsor elects to be governed by the limitation on sales loads or remains subject to present regulations with the new provision for a partial refund of sales load during the first three years of the plan.

E. *Additional Compensation for Sale of Mutual Fund Shares*

Although the portion of the sales load received by a broker-dealer is his basic compensation for the sale of mutual fund shares, there exist various means by which he can obtain additional compensation.

1. *Portfolio Brokerage—Reciprocity*

Trading by mutual funds in portfolio securities, mostly listed stocks, generates a great deal of commissions. The rapid growth of mutual funds in recent years, combined with an accelerated rate of portfolio turnover, has increased the importance of this source of compensation.

It has been the practice of mutual fund managers to direct the commissions from fund portfolio transactions to broker-dealers who sell shares of the fund or provide "research" or other services to the fund.[206] Prior to December 5, 1968, this could be accomplished by directing the brokers to whom they gave the funds' orders for execution to "give up" portions of the fixed minimum commissions to the other broker-dealers whom the fund managers wished to reward. On that date the national securities exchanges prohibited these "customer-directed give-ups."[207]

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[202] *Id.* § 16(c).
[203] *Id.* § 16(d).
[204] *Id.* § 16(e).
[205] S. Rep. No. 91-184, 91st Cong., 1st Sess. 20 (1969).
[206] Mutual Fund Report 169.
[207] *See* text accompanying notes 45-54 *supra*.

This prohibition, of course, does not prevent fund managers from giving portfolio business directly to broker-dealers whom they wish to reward. This practice, however, is much more cumbersome than the "give-up." Furthermore, it may expose the fund manager to liability if he gives a portfolio order to a broker-dealer who, he has reason to believe, is not likely to be able to execute the transaction at the price most favorable to the fund.[208] Aside from this fiduciary liability, a fund manager is potentially liable under the antitrust laws if he follows a regular practice of giving "reciprocal" portfolio commission business to particular broker-dealers for reasons unrelated to their ability to obtain the best execution for the fund.[209] A broker-dealer may be similarly liable if he refuses to sell fund shares unless he gets reciprocal business. A number of consent judgments directed against reciprocal business practices of this nature have recently been obtained by the Justice Department under section 1 of the Sherman Act,[210] and the *Silver* and *Kaplan* cases[211] give no reason to think that any implied exemption from the antitrust laws applicable to exchange fixing of minimum commission rates also insulates reciprocal arrangements from antitrust liability.[212]

2. *"Special Deals"*

Outside the reciprocal brokerage area, the NASD considers it inconsistent with just and equitable principles of trade for a mutual fund underwriter, in connection with the sale of mutual fund shares, to give an NASD member "anything of material value in addition to the discounts or concessions set forth in the currently effective prospectus [of the mutual fund]."[213] This interpretation has been construed to apply to gifts of more than twenty-five dollars in value, loans and guarantees, sales of securities on a preferential basis, extra discounts, wholesale overrides, and travel expenses unrelated to attendance at bona fide business meetings related to the fund, but not to apply to oc-

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208 *See* Hubshman Management Corp., SEC Securities Exchange Act Release No. 8557 (March 20, 1969).

209 *See* United States v. General Dynamics Corp., 258 F. Supp. 36 (S.D.N.Y. 1966). The court found that systematic reciprocal trading arrangements, whether coercive or based on mutual patronage, were anti-competitive practices and violated section 1 of the Sherman Act.

210 Wall St. J., June 20, 1969, at 40, col. 1.

211 Silver v. New York Stock Exchange, 373 U.S. 341 (1963); Kaplan v. Lehman Bros., 250 F. Supp. 562 (N.D. Ill. 1966), *aff'd*, 371 F.2d 409 (7th Cir.), *cert. denied*, 389 U.S. 954 (1967).

212 *See* text accompanying notes 90-112 *supra*.

213 NASD MANUAL, Interpretation of the Board of Gevernors ¶ 5262.

casional dinners or entertainment or to items of "reminder advertising" such as ballpoint pens and calendar pads.[214]

The NASD also considers it improper for a member to compensate its salesmen for selling mutual fund shares in a manner that does not "bear a reasonable relationship to the dealer discount set forth in the prospectus."[215]

3. *Sales Load on Reinvestment of Dividends*

In its *Mutual Fund Report*, the SEC found that more than half of the mutual fund shareholder accounts in existence in 1965 provided for automatic reinvestment of capital gains and dividend distributions. Although no fund charges a sales load on reinvestment of capital gains, almost half the funds at that time charged a full sales load on the reinvestment of income dividends.[216] A substantial part of this sales load is paid over by the underwriter to the dealer who originally sold the shares or, if he is no longer in business, to some other dealer. The SEC recommended that it be given authority to prohibit this "anomalous practice," on the ground that the reinvestment of dividends involves no sales effort justifying the imposition of a sales load.[217] Rather than giving the SEC the special authority it sought, the Senate committee left the matter to be dealt with under the general powers to regulate "excessive" sales loads granted to the NASD and the SEC by the Senate bill. The committee felt that the standards set forth in those provisions would "permit flexible treatment of the problem of sales loads on automatic investment of dividends, which involve little or no new selling effort."[218]

V

Underwriting

A. *Fixed Public Offering Price*

In the typical firm-commitment underwriting, the underwriters purchase stock from the issuer or selling stockholder and resell it either directly to the public or to "selected dealers" for resale to the public. The agreements among the underwriters and between the

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214 *Id.*
215 *Id.* ¶ 5263.
216 Mutual Fund Report 215.
217 *Id.* at 223.
218 *1968 Senate Report* 16.

underwriters and the "selected dealers" require that all sales to the public be made at the public offering price fixed by the underwriters, which provides for a profit, or "spread," above the price which the underwriters have agreed to pay the issuer or selling stockholder.[219]

No express statutory provision exempts these resale price maintenance agreements from the antitrust laws. The SEC held in 1945, however, that "[t]he mere making of agreements containing provisions for a fixed offering price . . . is not *per se* unlawful" under the Sherman Act, although, "like many other contracts, these may be entered into and performed under circumstances that amount to an unlawful suppression of competition."[220] But the SEC also held that the NASD has no authority to discipline a member who violates a price maintenance agreement.[221] The Commission felt that any rule or interpretation by the NASD requiring adherence to price maintenance agreements would be contrary to the provisions of section 15A(b)(8) of the Exchange Act, under which the rules of a national securities association may not be designed "to fix minimum profits . . . or . . . minimum rates of commissions, allowances, discounts or other charges."

Agreements among underwriters and with "selected dealers" also customarily provide that a discount from the public offering price may be allowed to any NASD member. Under the NASD's Rules of Fair Practice, a member is prohibited from dealing with non-member brokers or dealers except at the same prices as such member accords to the general public,[222] and this rule is interpreted to bar members from participating in any underwriting syndicate or selling group that includes non-members.[223] This restriction against non-member participation in underwriting is a principal incentive for a broker-dealer to join the NASD.

B. *Level of Underwriting Compensation*

1. *Statutory Restrictions*

The federal securities laws impose no direct restrictions on the amount of compensation that may be paid to underwriters and dealers in connection with a public offering, but full disclosure of all under-

219 United States v. Morgan, 118 F. Supp. 621, 693 (S.D.N.Y. 1953).

220 National Association of Securities Dealers, Inc., 19 S.E.C. 424, 464 (1945). Judge Medina expressed his "complete agreement" with this position in United States v. Morgan, 118 F. Supp. 621, 699 (S.D.N.Y. 1953), an antitrust action against 16 leading underwriters.

221 National Association of Securities Dealers, Inc., 19 S.E.C. 424, 445 (1945).

222 NASD Rules art. III, § 25.

223 NASD Rules, Interpretation of the Board of Governors following article III, § 24.

writing compensation is required in public offerings that are subject to the registration requirements of the Securities Act of 1933.[224]

By way of statute or regulation, a number of states impose detailed restrictions on the amount of underwriting compensation that may be paid on issues qualified for sale in those states,[225] and other states give discretionary power to administrative officials to deny registration of an issue if "unreasonable" underwriting compensation will be paid.[226]

2. *NASD Supervision*

The NASD "five percent mark-up policy" is not applied to fixed-price underwritten offerings.[227] Since 1961, however, the NASD has interpreted its Rules of Fair Practice as prohibiting members from participating in underwritings "in which the underwriting arrangements as a whole are unfair or unreasonable."[228] In determining fairness or reasonableness, the NASD takes into account the size of the underwriting, whether it is being sold on a firm commitment or best efforts basis, the type of security, the nature and amount of compensation, and other relevant factors. In determining the amount of compensation, the NASD considers the gross amount of the underwriters' discount, any expenses borne by the issuer or selling stockholder that would normally be borne by the underwriters, and any stock or options acquired by the underwriters or related parties. The arrangements are normally considered unfair or unreasonable per se if the underwriters or related parties receive stock, options or warrants that are transferable within a period of one year from the date of the offering.[229]

To implement these restrictions, the NASD currently requires any member acting as managing underwriter of a registered or intrastate public offering to file with it, prior to the offering, copies of the

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[224] Securities Act of 1933, schedule A, item 17, 15 U.S.C. § 77aa (1964).

[225] Selling commissions are limited to 15% of the offering price in a number of states. *See, e.g.*, CALIF. ADMIN. CODE tit. 10, § 260.140.20; IND. SEC. COMM. REG., rule 19.02; MICH. DEP'T OF COMM., SEC. RULES, pt. 3, rule 706.5; MINN. REGS. S. DIV. 20; OHIO DIV. OF SEC. reg. CO-105(A).

[226] The Uniform Securities Act contains a provision permitting the administrator to suspend or revoke a registration statement if the offering "has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation . . . ." UNIFORM SEC. ACT § 306(F). This provision has been adopted in Alabama, Colorado, Hawaii, Indiana, Kentucky, Montana, Oklahoma, Oregon, Puerto Rico, Washington, and Wyoming.

[227] NASD Rules, Interpretation of the Board of Governors following article III, § 4.

[228] NASD Rules, Interpretation of the Board of Governors following article III, § 1.

[229] *Id. See also* state restrictions discussed in *PLI's Conference on "Going Public,"* 2 REV. OF SEC. REGS. 846 (1969).

offering prospectus and other documents describing the underwriting arrangements. These are reviewed by the NASD's Committee on Underwriting Arrangements.[230] A detailed set of guidelines for underwriters' compensation is reported to have been approved by the NASD Committee on Underwriting Arrangements and commented on by the SEC, and is expected to be issued early in 1970.[231] The number of issues reviewed by the committee increased from 428 in 1966 to 1,074 in 1967 to 2,108 in 1968. The underwriting arrangements in 328 issues were initially found "unfair or unreasonable" in 1968 as against seventeen in the previous year.[232] In almost all of these cases, the arrangements were modified to meet the committee's objections.[233]

VI

Interest Income

Interest charged on customers' margin accounts constitutes a substantial part of the income of broker-dealers, particularly that of the larger NYSE member firms. The income and expense reports filed by NYSE members doing public commission business in 1960 showed that thirteen percent of their gross income came from interest received from customers' balances.[234]

A. *Disclosure of Interest Rate*

The *Special Study* found that "normally money is lent to margin customers at the going call-money rate plus one or one-half point."[235] Margin loans by registered broker-dealers were specifically exempted from the 1968 federal Consumer Credit Protection Act[236] on the ground that the SEC already had authority under the Exchange Act to require appropriate disclosure.[237]

In December 1969 the SEC adopted a new rule 10b-16. It requires broker-dealers who extend credit to their customers to provide the customers with (*1*) an initial statement disclosing the basis on which interest will be charged, the initial interest rate, the conditions under which it may be changed, and any additional charges or liens; and

230 NASD Rules, Interpretation of the Board of Governors following article III, § 1.

231 3 Rev. of Sec. Regs. 999 (1970).

232 NASD, 1968 Report to Members 6, 7.

233 *Id.*

234 Special Study, pt. 2, at 39.

235 Special Study, pt. 1, at 396.

236 15 U.S.C. § 1603(2) (Supp. IV, 1969).

237 S. Rep. No. 392, 90th Cong., 1st Sess. 9 (1967).

(2) a quarterly statement disclosing the interest charged and the manner in which it was computed.[238]

B. *Use of Customers' Free Credit Balances*

The *Special Study* found that free credit balances in customers' accounts are an important source of financing for broker-dealers, particularly exchange members. Although a few states require segregation of customers' credit balances from firm assets, balances are generally available for firm operations, including the financing of loans to margin customers.[239]

Under SEC rule 15c3-2, adopted in 1964, a broker-dealer must, at least quarterly, send to each customer whose free credit balance may be used for the firm's business purposes a notice informing him of this fact and that the funds are payable to the customer on demand.[240]

The *Special Study* also found that most firms pay no interest to customers on these balances, and that those that do pay interest do so only on large balances that are reinvested within a short period of time. Frequently, interest is paid only when the customer requests it.[241] There is no rule requiring payment of interest on these balances; in fact, the NYSE prohibits its members from paying interest "on any credit balance created for the purpose of receiving interest thereon"[242] on the ground that to do so would violate section 21 of the Banking Act of 1933, which bars broker-dealers from engaging in the business of "receiving deposits."[243] To implement this policy, the NYSE "has informally promulgated the view that interest can be paid on free credit balances only at a half point or more below the going call-money rate."[244] The SEC's rule 15c3-2 does not adopt the recommendation of the *Special Study* that notice to customers disclose "that interest is not paid on such balances (or the circumstances in which interest is paid)."[245]

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238 *Proposed*, SEC Securities Exchange Act Release No. 8594 (May 2, 1969); *adopted*, SEC Securities Exchange Act Release No. 8773 (Dec. 8, 1969).

239 SPECIAL STUDY, pt. 1, at 399.

240 *Proposed*, SEC Securities Exchange Act Release No. 7266 (March 12, 1964); *adopted*, SEC Securities Exchange Act Release No. 7325 (May 27, 1964).

241 SPECIAL STUDY, pt. 1, at 395.

242 NYSE rule 436.

243 12 U.S.C. § 378 (Supp. IV, 1969).

244 SPECIAL STUDY, pt. 1, at 395.

245 *Id.* at 415. The SEC stated that "this information is not directly pertinent to the purpose of the rule; *i.e.*, to put customers on notice that free credit balances left with the broker-dealer may be used in the business and therefore may be at risk." SEC Securities Exchange Act Release No. 7325 (May 27, 1964).

New Law Affects Many Investors

Many investors are affected by the law and Regulation X. More than 30 million Americans own stocks and bonds and margin credit totaling several billions of dollars is outstanding at any given time.

Regulation X requires a borrower to comply with the Federal regulation that applies to the person or firm extending him credit to buy a security. If the credit is obtained from a broker-dealer, for example, then the borrower—as well as the broker-dealer—must comply with Regulation T. If a person borrows abroad, he [illegible]st comply with the margin regulation that would [illegible]ly if the credit were obtained in the United States—even if the foreign lender is not subject to any margin regulation.

Violations

A borrower is subject to prosecution if a violation of the law or regulation is willful. Any person who willfully aids or abets the violation of any provision of Regulation X is considered to be a violator and could be prosecuted.

Remember! The penalties for violations are severe in many cases. Upon conviction they range as high as a $10,000 fine and 5 years in jail.

Get The Facts

[illegible]et the facts and familiarize yourself with the margin [illegible]ulations *before* you obtain credit to buy securities.

Further information may be obtained from the Board of Governors of the Federal Reserve System in Washington or from any Federal Reserve Bank or office. Federal Reserve Banks are located at Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas and San Francisco. Other offices are located at Buffalo, Cincinnati, Pittsburgh, Baltimore, Charlotte, Birmingham, Jacksonville, Miami, Nashville, New Orleans, Detroit, Little Rock, Louisville, Memphis, Helena, Denver, Oklahoma City, Omaha, El Paso, Houston, San Antonio, Los Angeles, Portland, Salt Lake City and Seattle.

Board of Governors of the Federal Reserve System
Washington, D.C. 20551

If You Borrow To Buy Stock—

Planning to buy some stock on credit?

Whatever your objective—speculation or a long-term investment—if you need credit to close the deal, there is something new you should know about.

There's a new Federal law—passed by Congress effective November 1, 1971—that now requires the borrower, as well as the lender, to comply with the Government's rules relating to the use of credit in purchasing securities, even when the borrower obtains the credit outside the United States.

Before that date, the responsibility of complying with these rules generally was on the lender—a bank, broker-dealer, or other type of lending institution. Now the responsibility for compliance is shared by the lender *and* the borrower. Borrowers who willfully obtain credit on securities illegally are subject to severe penalties. T'ʰᵉ maximum penalty upon conviction is a $10,000 fine 5 years in jail.

Regulation X

The rules that borrowers must follow are described in Regulation X, issued by the Board of Governors of the Federal Reserve System. This regulation is entitled "Rules Governing Borrowers Who Obtain Securities Credit" and free copies are available at Federal Reserve offices throughout the country and most U.S. embassies abroad. Banks, broker-dealers and many other lenders also have copies of the Regulation or are familiar with its provisions. Ask your banker or broker about them.

Margin Regulations – What Are They?

Since the early 1930's, the Federal Reserve has been directed by law to restrain the excessive use of cr for the purpose of buying securities. This is done by setting a limit on the amount of funds that banks, broker-dealers and others may lend on stock and convertible bonds. The limit is always less than the market value of the securities that are pledged as collateral. The difference between the credit value and the market value is known as the customer's margin.

Regulation X is one of four regulations issued by the Federal Reserve relating to securities credit. The other three apply to the various types of *lending* institutions. Regulation T, for example, sets forth the rules that *broker-dealer firms* must follow in extending credit on securities. Regulation U applies to *bank* credit for the purpose of purchasing or carrying margin stocks, while Regulation G applies to *all other types of lenders* who extend securities credit.

How Margin Works

When the Federal Reserve sets a margin requirement it is, in effect, specifying the minimum down payment that must be made in a transaction. For example, if the margin requirement is 55 per cent, a borrower subject to Regulation X would be required to make a down payment equal to at least 55 per cent of the total dollar amount of the transaction. He could obtain credit for the remaining 45 per cent.* If the Federal Reserve Board decided that an excessive amount of credit was being extended at this margin level, it could increase the required down payment for *new* credit. Conversely, if the Board decided that sound transactions were being unnecessarily restrained at this margin level, it could lower the required down payment.

* If he does not have the cash, he could satisfy the margin requirements by depositing stock collateral with a sufficient loan value. For example, he could borrow $1,000 by depositing stock having a market value of $2,222 (45 per cent of 222 equals about $1,000).

Why Government Regulation?

The idea thatGovernment regulation of securities credit might play an essential role in preventing money crises goes back more than 60 years. In 1910 a study by the National Monetary Commission showed that extensive use of stock market credit accompanied major financial crises from 1873 to 1907. Direct controls on the use of securities credit were not imposed, however, until 1933.

In that year, Congress directed the Federal Reserve to restrain the undue use of *bank* credit for speculation in securities. The following year—in the Securities E change Act of 1934—the Federal Reserve was spec cally authorized to issue regulations setting limits on the amount of credit that *broker-dealers, banks*, and any *other lenders* may provide for the purpose of purchasing or carrying securities. Until 1969, these regulations applied only to securities listed on national stock exchanges such as the New York and American exchanges. In that year, the law was expanded to include securities sold outside the exchanges—in the so-called "Over-the-Counter" market. About 500 of these OTC securities—with characteristics similar to those listed on the exchanges—are now subject to margin regulation. The Federal Reserve periodically publishes a list of OTC margin stocks for the information of the public.

The borrower became subject to margin regulations through Title III of Public Law 91-508, effective November 1, 1971. The Federal Reserve issued Regulation X to implement that law.

The Congressional committees that prepared the 1970 law expressed concern about the potentially upsetting effect that borrowing abroad to buy U.S. stocks might have on securities markets in the United States. Consequently the law is aimed particularly at foreign borrowing. However, its provisions apply as well to borrowings in this country.

BOARD OF GOVERNORS
of the
FEDERAL RESERVE SYSTEM

SECURITIES CREDIT TRANSACTIONS

REGULATION X

(12 CFR 224)

Effective November 1, 1971

REGULATION G

(12 CFR 207)

As amended effective March 30, 1971

REGULATION T

(12 CFR 220)

As amended effective May 15, 1970

REGULATION U

(12 CFR 221)

As amended effective July 10, 1971

NOVEMBER 1971

GENERAL CONTENTS

This pamphlet contains the regulations, as listed below, issued by the Board of Governors of the Federal Reserve System relating to margin requirements on securities credit transactions.

REGULATION X—RULES GOVERNING BORROWERS WHO OBTAIN SECURITIES CREDIT Page 5

REGULATION G—SECURITIES CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS Page 11

REGULATION T—CREDIT BY BROKERS AND DEALERS Page 21

REGULATION U—CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCKS Page 37

STATUTORY APPENDIX Page 47

Any inquiry relating to Regulations X, G, and U should be addressed to the Federal Reserve Bank of the Federal Reserve district in which the inquiry arises. Any inquiry relating to Regulation T should be addressed to a national securities exchange or a national securities association of which the person making the inquiry is a member or the facilities of which are used for his transactions, or, if this is not practicable, the inquiry should be addresed to the Federal Reserve Bank of the district in which the inquiry arises.

The forms furnished with these regulations are reduced in size and are for information only. Copies of these forms for actual use and of other forms required by the regulations can be obtained from any Federal Reserve Bank.

DETAILED TABLE OF CONTENTS

Page

REG. X—RULES GOVERNING BORROWERS WHO OBTAIN SECURITIES CREDIT

SEC. 224.1—SCOPE OF PART 5

SEC. 224.2—GENERAL RULE 6
(a) Credit obtained from within the United States 6
(b) Credit obtained from outside the United States 6

SEC. 224.3—EXEMPTIONS 7

SEC. 224.4—REPORTS AND RECORDS 7

SEC. 224.5—DEFINITIONS 7
(a) Acting on behalf of or in conjunction with 7
(b) Bank 7
(c) Broker/dealer 7
(d) Foreign lender 7
(e) G-lender 7
(f) Indirectly secured 8
(g) Lender 8
(h) Margin security 8
(i) Offshore debt security 8
(j) Purpose credit 8
(k) Obtain credit 8
(l) United States 8

SEC. 224.6—MISCELLANEOUS PROVISIONS 8
(a) Innocent mistake 8
(b) Aiding or abetting 8

FORM X-1—RECORD OF FACTS OF CREDIT 9

REG. G—SECURITIES CREDIT BY PERSONS OTHER THAN BANKS, BROKERS OR DEALERS

SEC. 207.1—GENERAL RULE 11
(a) Registration 11
(b) Termination of registration 11
(c) Definition of lender and applicability of margin requirements 11
(d) Credit on convertible debt securities 12
(e) Statements as to purpose of credit 12
(f) Credit extended to person subject to Regulation T 12
(g) Combining purpose credit extended to the same customer 13
(h) Purpose and nonpurpose credit extended to the same person 13
(i) Purpose credit secured both by margin securities and by other collateral 13
(j) Withdrawals and substitutions of collateral 13
(1) General rule 13
(2) Same-day substitution of collateral 13

SEC. 207.2—DEFINITIONS 14
(a) Statutory meanings 14
(b) In the ordinary course of his business 14
(c) Purpose 14
(d) Margin security 14
(e) Registered equity security 14
(f) OTC margin stock 14
(g) Purchase and sale 15
(h) Customer 15
(i) Indirectly secured 15
(j) Stock 15

SEC. 207.3—REPORTS AND RECORDS 15

SEC. 207.4—MISCELLANEOUS PROVISIONS 15
(a) Stock option and employee stock purchase plans 15
(b) Extensions and renewals 16
(c) Reorganization or recapitalization 16
(d) Mistakes in good faith 16
(e) Arranging for credit 16
(f) Combined purchase of mutual funds and insurance 16

FORM G-3—STATEMENT OF PURPOSE 19

[SEC. 207.5—SUPPLEMENT, containing maximum loan values, retention requirement, and requirements for inclusion on list of OTC margin stock, is printed separately.]

REG. T—CREDIT BY BROKERS AND DEALERS

SEC. 220.1—SCOPE OF PART 21

SEC. 220.2—DEFINITIONS 21
(a) Statutory meanings 21
(b) Creditor 21
(c) Customer 21
(d) Registered security 21
(e) OTC margin stock 21
(f) Margin security 22
(g) Exempted security 22
(h) Nonequity security 22

SEC. 220.3—GENERAL ACCOUNTS 22
(a) Contents of general account 22
(b) General rule 22
(c) Maximum loan value and current market value 23
(d) Adjusted debit balance 24
(e) Liquidation in lieu of deposit 24
(f) Extensions of time 24
(g) Transactions on given day 24
(h) Unissued securities 25

SEC. 220.4—SPECIAL ACCOUNTS 25
(a) General rule 25
(b) Special omnibus account 25
(c) Special cash account 26
(d) Special arbitrage account 27
(e) Special commodity account 27
(f) Special miscellaneous account 27
(g) Specialist's account 28
(h) Special subscriptions account 28
(i) Special bond account 29
(j) Special convertible debt security account 29
(k) Special equity funding account 29

SEC. 220.5—BORROWING BY MEMBERS, BROKERS, AND DEALERS 30
(a) General rule 30
(b) Agreements of nonmember banks 30
(c) Borrowing from other creditors 30

SEC. 220.6—CERTAIN TECHNICAL DETAILS 30
(a) Accounts of partners 30
(b) Contribution to joint venture 30
(c) Guaranteed accounts 30
(d) Transfer of accounts 30
(e) Reorganizations 31
(f) Time of receipt of funds or securities 31
(g) Interest, service charges, etc. 31
(h) Borrowing and lending securities 31
(i) Credit for clearance of securities 32
(j) Foreign currency 32
(k) Innocent mistakes 32

SEC. 220.7—MISCELLANEOUS PROVISIONS 32
(a) Arranging for loans by others 32
(b) Maintenance of credit 32
(c) Statement of purpose of loan 32
(d) Reports 32

Page

REG. T—CREDIT BY BROKERS AND DEALERS (cont.)

SEC. 220.7—MISCELLANEOUS PROVISIONS (cont.)
- (e) Additional requirements by exchanges and creditors ... 32
- (f) Credit by insurance companies that issue variable annuity contracts ... 32

FORM T-4—STATEMENT OF PURPOSE ... 35

[SEC. 220.8—SUPPLEMENT, containing maximum loan values, margin for short sales, retention requirement, and requirements for inclusion on list of OTC margin stock, is printed separately.]

REG. U—CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCKS

SEC. 221.1—GENERAL RULE ... 37
- (a) Purpose credit secured by stock ... 37
- (b) Substitutions and withdrawals ... 37
- (c) Same-day transactions ... 38
- (d) Single credit rule ... 38

SEC. 221.2—EXCEPTIONS TO GENERAL RULE ... 38

SEC. 221.3—MISCELLANEOUS PROVISIONS ... 39
- (a) Required statement as to stock-secured credit ... 39
- (b) Purpose of a credit ... 39
- (c) Indirectly secured ... 40

Page
- (d) OTC margin stock ... 40
- (e) Renewals and extensions of maturity ... 40
- (f) Transfers ... 40
- (g) Reorganizations and recapitalizations ... 41
- (h) Mistakes in good faith ... 41
- (i) Action for bank's own protection ... 41
- (j) Reports ... 41
- (k) Definitions ... 41
- (l) Stock ... 41
- (m) Credit subject to § 221.1 ... 41
- (n) Segregation of collateral ... 41
- (o) Specialist ... 41
- (p) Subscriptions issued to stockholders ... 42
- (q) Credit to certain lenders ... 42
- (r) Convertible securities ... 42
- (s) Credit secured by collateral other than stocks ... 43
- (t) Credit on convertible debt securities ... 43
- (u) Arranging for credit ... 43
- (v) Margin stock ... 43
- (w) OTC market maker exemption ... 43
- (x) Combined purchase of mutual funds and insurance ... 44

FORM U-1—STATEMENT OF PURPOSE ... 45

[SEC. 221.4—SUPPLEMENT, containing maximum loan values, retention requirement, and requirements for inclusion on list of OTC margin stock, is printed separately.]

STATUTORY APPENDIX ... 47

REGULATION X

(12 CFR 224)

Effective November 1, 1971

RULES GOVERNING BORROWERS WHO OBTAIN SECURITIES CREDIT *

SECTION 224.1—SCOPE OF PART

This Part 224 (Regulation X) contains Rules and Regulations promulgated by the Board of Governors of the Federal Reserve System ("the Board") under the Securities Exchange Act of 1934 as amended ("the Act") and applies to all persons described below who obtain, receive, or enjoy the beneficial use of credit for the purpose of purchasing or carrying securities.[1] For definitions of technical terms see section 224.5, Parts 207, 220, and 221 (Margin Regulations G, T, and U) and the Statutory Appendix. The purpose of this part (Regulation X) is to prevent the infusion of unregulated credit obtained both outside and within the United States into United States securities markets in circumvention of the provisions of the Board's margin regulations or by borrowers falsely certifying the purpose of a loan or otherwise wilfully and intentionally evading the provisions of those regulations. When the term "obtain credit" is used in this part (Regulation X) it means "obtain, receive, or enjoy the beneficial use of credit" and when the term "purpose credit" is used, it means "credit for the purpose of purchasing or carrying securities." When the term "borrower" is used, it means a person who obtains credit. This part (Regulation X) implements section 7(f) of the Act, and generally applies to borrowers who are:

(a) Persons who obtain credit from within the United States, or

(b) Those persons who obtain credit from outside the United States who are:

(1) United States persons,[2]

(2) Foreign persons who are controlled by United States persons,[3] or

* This text corresponds to the Code of Federal Regulations, Title 12, Chapter II, Part 224, cited as 12 CFR 224. The words "this part," as used herein, mean Regulation X.

[1] 15 U.S.C. 78g.

[2] For definition of the term "United States person," see Statutory Appendix, section 7(f)(2)(A).

[3] For definition of the term "foreign person controlled by a United States person," see Statutory Appendix, section 7(f)(2)(C).

(3) Foreign persons acting on behalf of or in conjunction with [4] United States persons.

SECTION 224.2—GENERAL RULE

(a) **Credit obtained from within the United States.** A borrower shall not obtain any purpose credit from within the United States unless he does so in compliance with the following conditions:

(1) Credit obtained from a G-lender shall conform to the provisions of Part 207 (Regulation G), which is hereby incorporated in this part (Regulation X). When the term "G-lender" is used in this part (Regulation X), it means a person who is not a broker/dealer or bank, who in the ordinary course of his business extends, maintains, or arranges credit that is secured, directly or indirectly, in whole or in part, by collateral that includes any margin securities, and who is subject to the registration requirement of section 207.1(a) of Part 207 (Regulation G).

(2) Credit obtained from a broker/dealer shall conform to the provisions of Part 220 (Regulation T), which is hereby incorporated in this part (Regulation X). When the term "broker/dealer" is used in this part (Regulation X), it means a person who is a broker or dealer, including every member of a national securities exchange, and includes a foreign branch or subsidiary of a broker/dealer.

(3) Credit obtained from a bank shall conform to the provisions of Part 221 (Regulation U), except for section 221.2(i). Except for such section, Part 221 (Regulation U) is hereby incorporated in this part (Regulation X). When the term "bank" is used in this part (Regulation X), it means a bank that is subject to Part 221 (Regulation U).[5]

(b) **Credit obtained from outside the United States.** (1) A United States person or foreign person controlled by a United States person or acting on behalf of or in conjunction with such a person shall not obtain any purpose credit [6] from outside the United States except in compliance with the following conditions:

(i) Credit obtained from a foreign branch of a G-lender shall conform to the provisions of Part 207 (Regulation G), except that the requirement of section 207.1(c) as to obtaining a statement of the purpose of the credit shall not apply.

(ii) Credit obtained from a foreign branch or subsidiary of a broker/dealer shall conform to the provisions of Part 220 (Regulation T).

(iii) Credit obtained from a foreign branch of a bank shall conform to the provisions of Part 221 (Regulation U) which would apply if the credit were obtained from the head office of the bank in the United States, except that the requirement of section 221.3(a) of Part 221 (Regulation U) as to obtaining a statement of the purpose of the credit shall not apply.

(iv) Credit obtained from a foreign lender shall conform to the provisions of Part 207 (Regulation G) which would apply if the person extending, arranging, or maintaining the credit were a G-lender, except that the requirement of section 207.1(c) of Part 207 (Regulation G) as to obtaining a statement of the purpose of the credit shall not apply. When the term "foreign lender" is used in this part (Regulation X) it means any person, other than a United States person, who in the ordinary course of his business extends, maintains, or arranges purpose credit outside the United States and who is not a foreign branch or subsidiary of a broker/dealer, a foreign branch of a bank, or a foreign branch of a G-lender.

(2) The provisions of subparagraph (1) of this paragraph 224.2(b) shall not apply to credit extended before November 1, 1971, except that as to credit extended after October 26, 1970, the requirements as to withdrawals and substitutions of collateral shall apply after May 1, 1972, as follows: the requirements in paragraph 207.1(j) of Part 207 (Regulation G) shall apply to credit obtained from a foreign branch of a G-lender or from a foreign lender; the requirements in paragraph 220.3(b) of Part 220 (Regulation T) shall apply to credit obtained from a foreign branch or subsidiary of a broker/dealer; and the requirements in paragraph 221.1(b) of Part 221 (Regulation U) shall apply to credit obtained from a foreign branch of a bank.

(3) **Record of credit.** Every borrower subject to this Part 224 (Regulation X) who obtains any credit from a lender described in subdivisions (i), (iii), or (iv) of paragraph 224.2(b)(1), if such credit is secured directly or indirectly, in whole or in part, by collateral that includes any security, shall prepare and retain in his records, for at least 6 years after such credit is extinguished, a record

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[4] For definition of the term "acting on behalf of or in conjunction with," see section 224.5(a) of this part (Regulation X).

[5] For definition of the term "bank" meaning "bank that is subject to Regulation U," see section 224.5(b) of this part (Regulation X) and Statutory Appendix, section 3(a)(6).

[6] For definition of the term "purpose credit," see section 224.5(j) of this part (Regulation X).

substantially in conformity with the requirements of Federal Reserve Form X-1.

SECTION 224.3—EXEMPTIONS

The following classes of persons shall be exempted from the provisions of section 7(f) of the Act and this part (Regulation X) to the extent described below:

(a) A United States person whose permanent residence is outside the United States, and who does not during any calendar year obtain a total of more than $5,000 or have outstanding at any time during any calendar year a total of more than $5,000 in credit obtained outside the United States to purchase or carry margin securities.

(b) A borrower who is not a United States person, but is controlled by or acting on behalf of or in conjunction with such person, who obtains credit for the purpose of *bona fide* clearing, market making, or arbitrage transactions in offshore debt securities that are convertible into margin securities, except that any credit outstanding against collateral consisting of such securities shall be brought into conformity with the other provisions of this part (Regulation X)[7] upon the conversion of such securities into margin securities.

(c) A borrower who is not a United States person, but is controlled by or acting on behalf of or in conjunction with such person, who obtains credit from outside the United States, which borrower has been exempted by the Board of Governors of the Federal Reserve System, by Order, from the requirements of this part (Regulation X), either unconditionally or upon specified terms and conditions or for stated periods, upon a finding that exceptional circumstances warrant the granting of such an exemption, and that the exemption is consonant with the purposes of section 7(f) of the Act and the provisions of this part (Regulation X).

SECTION 224.4—REPORTS AND RECORDS

Every borrower described in section 224.1 who obtains any credit that is secured directly or indirectly, in whole or in part, by collateral that includes any securities, shall maintain such records and file such reports as may be prescribed by the Board of Governors of the Federal Reserve System to enable it to perform the functions conferred upon it by the Act.

[7] Including Parts 207, 220, or 221 (Regulations G, T, and U) where applicable.

SECTION 224.5—DEFINITIONS

Unless the context otherwise requires, or it is otherwise specified herein, the terms used in and for the purposes of this part (Regulation X) have the meanings given them in this section 224.5, in sections 3(a) or 7(f) of the Act, or in Parts 207, 220, or 221 (Regulations G, T, or U). The relevant portions of sections 3(a) and 7(f) of the Act are set forth in the Statutory Appendix. In the case of inconsistency between definitions appearing in this section 224.5 and those appearing in Parts 207, 220, or 221 (Regulations G, T, or U), the definition appearing in the regulation that applies to the particular credit involved, whether Parts 207, 220, or 221 (Regulations G, T, or U), shall prevail.

(a) The term **"acting on behalf of or in conjunction with"** in reference to a foreign person means obtaining credit for the purpose of purchasing or carrying a security in which, or in the income or gains or losses from which, a United States person or a foreign person controlled by a United States person has a substantial direct or indirect beneficial interest. Absent these factors the term does not include an interest derived solely from the ownership of less than 50 per cent of the outstanding capital stock issued by such foreign person who is obtaining such credit.

(b) The term **"bank"** means a bank as defined in section 3(a)(6) of the Act, including a foreign branch of a bank, except that such term does not include a bank which is a member of a national securities exchange, a foreign affiliate of a bank, or a foreign bank.

(c) The term **"broker/dealer"** means any broker or dealer including every member of a national securities exchange, and includes a foreign branch or subsidiary of a broker/dealer.

(d) The term **"foreign lender"** means a person, other than a United States person, who in the ordinary course of his business extends, maintains, or arranges purpose credit outside the United States and who is not a foreign branch or subsidiary of a broker/dealer, a foreign branch of a bank, or a foreign branch of a G-lender.

(e) The term **"G-lender"** means a person who is not a broker/dealer or bank, who in the ordinary course of his business extends, maintains, or arranges credit that is secured, directly or indirectly, in whole or in part, by collateral that includes any margin securities, and who is subject to the registration requirement of section 207.1(a) of Part 207 (Regulation G).

(f) The term **"indirectly secured"** includes any arrangement with the lender under which the right or ability to sell, pledge, or otherwise dispose of securities owned by the borrower (or by any other person who has made the use of such securities available to the borrower) is in any way restricted as long as the credit remains outstanding, or under which the exercise of such right, whether by written agreement or otherwise, is or may be cause for acceleration of maturity of the credit. The foregoing shall not apply, however—

(1) if such restriction arises solely by virtue of an arrangement with the lender which pertains generally to the borrower's assets unless a substantial part of such assets consists of margin securities, or

(2) if the lender in good faith has not relied upon such securities as collateral in the extension or maintenance of the particular credit, or

(3) to securities held by the lender only in the capacity of custodian, depositary, or trustee, or under similar circumstances, if the lender in good faith has not relied upon such securities as collateral in the extension or maintenance of the particular credit.

(g) The term **"lender"** means a person who in the ordinary course of his business extends, maintains, or arranges for credit, including a G-lender, a broker/dealer, a bank, and a foreign lender.

(h) The term **"margin security"** shall have the meaning of "margin security" as defined in section 207.2(d) of Part 207 (Regulation G) if the borrower is obtaining credit from a G-lender or a foreign lender, the meaning of "margin security" as defined in section 220.2(f) of Part 220 (Regulation T) if the borrower is obtaining credit from a broker/dealer, and the meaning of "margin stock" as defined in section 221.3(v) of Part 221 (Regulation U) if the borrower is obtaining credit from a bank.

(i) The term **"offshore debt security"** as to this part (Regulation X) means a debt security offered only outside the United States, the purchase of which by a United States person would give rise to a liability under the Interest Equalization Tax (26 U.S.C. 4911 *et seq*).

(j) The term **"purpose credit"** means credit for the purpose of purchasing or carrying securities. The purpose of a credit is determined by substance rather than form. The following are some examples of purpose credit:

(1) Credit which is for the purpose, whether immediate, incidental, or ultimate, of purchasing or carrying a security is "purpose credit," despite any temporary application of the funds otherwise.

(2) Credit to enable the borrower to reduce or retire indebtedness which was originally incurred to purchase a security is for the purpose of "carrying" such a security.

(3) Credit that is secured directly or indirectly, in whole or in part, by collateral that includes any securities, is presumed to be for the purpose of purchasing or carrying securities, unless the borrower has complied with the requirements of Part 207 (Regulation G), Part 220 (Regulation T), or Part 221 (Regulation U) as to the statement of the purpose of a credit, if such requirements are applicable, or in the case of credit obtained from a foreign lender, can furnish satisfactory evidence of the use of the credit for a purpose other than purchasing or carrying securities.

(4) An extension of credit provided for in a plan, program, or investment contract offered or sold or otherwise initiated after August 31, 1969, which provides for the acquisition both of any securities and of goods, services, property interests, or investments.

(k) The term **"obtain credit"** means to obtain, receive, or enjoy the beneficial use of credit.

(l) The term **"United States"** includes any State of the United States, the District of Columbia, Puerto Rico, the Canal Zone, the Virgin Islands, or any other possession of the United States.

SECTION 224.6—MISCELLANEOUS PROVISIONS

(a) **Innocent mistake.** An innocent mistake made in good faith by a borrower in connection with the obtaining of a credit shall not be deemed to be a violation of this part (Regulation X) if promptly after discovery of the mistake the borrower takes whatever action is practicable to remedy the non-compliance.

(b) **Aiding or abetting.** Any person who wilfully aids or abets the violation by any other person of any provision of this part (Regulation X) shall be deemed to be in violation of this part (Regulation X). For the purpose of this paragraph, the term "aids or abets" shall include, but not be limited to, counsels, commands, induces, or procures.

F.R. Form X-1
11-71

SPECIMEN ONLY

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

RECORD WHICH BORROWERS ARE REQUIRED TO MAKE AND MAINTAIN
OF FACTS CONCERNING CREDIT COLLATERALIZED BY SECURITIES

**WHEN SUCH CREDIT IS OBTAINED FROM
OUTSIDE THE UNITED STATES**

*PURSUANT TO REGULATION X
"RULES GOVERNING BORROWERS WHO OBTAIN SECURITIES CREDIT"
(FEDERAL RESERVE FORM X-1)

A FALSE OR DISHONEST STATEMENT BY A BORROWER ON THIS FORM OR ANY SCHEDULE THERETO MAY BE PUNISHABLE BY FINE OR IMPRISONMENT (U.S. CODE, TITLE 15, SECTION 78ff AND TITLE 18, SECTION 1001)

Unless specifically exempted from the provisions of Regulation X, the following borrowers must complete this record or a record substantially in conformity with this form at or prior to the time when credit is obtained from any source outside the United States, other than a foreign branch or subsidiary of a United States broker or dealer who is subject to Regulation T, if the credit is secured in any way by collateral that includes any United States security or security registered on a national securities exchange:

United States persons,
Foreign persons who are controlled by United States persons, or
Foreign persons acting on behalf of or in conjunction with United States persons.

Date credit obtained .... Amount of credit $...

Purpose of this credit (state in detail) ....

....

Credit is secured by following securities (attach schedule including name of issuer, type or class of securities, number of shares, and market value on date credit is obtained) ....

....

Name and address of lender extending credit ....

....

Name and address of United States person the borrower is controlled by, or is acting on behalf of or in conjunction with, if applicable (such person must obtain and retain a copy of the filled in form) ....

....

Name, address, and occupation of any person arranging credit ....

....

The undersigned hereby certifies and affirms that to the best of my (our) knowledge and belief the information contained herein is true, accurate, and complete.

SIGNED .... SIGNED ....
(Manual signature) (Date) (Manual signature) (Date)

....
(Type or print name) (Type or print name)

Address of borrower ....

* Copies of Regulation X may be obtained from any Federal Reserve Bank in the United States and are available at United States Embassies and consular posts.

THIS FORM MUST BE RETAINED BY THE BORROWER AND BY ANY UNITED STATES PERSON REQUIRED TO OBTAIN AND RETAIN A COPY FOR AT LEAST 6 YEARS AFTER THE TERMINATION OF THIS CREDIT

The terms used on this record have the meanings given them below; for additional definitions, please refer to section 224.5 of Regulation X, section 3(a) or 7(f) of the Securities Exchange Act of 1934 as amended, or Regulations G, T, or U issued by the Board of Governors of the Federal Reserve System.

The term **"United States person"** includes a person which is organized or exists under the laws of any State or, in the case of a natural person, citizen or resident of the United States; a domestic estate; or a trust in which one or more of the foregoing persons has a cumulative direct or indirect beneficial interest in excess of 50 per centum of the value of the trust.

The term **"foreign person controlled by a United States person"** includes any noncorporate entity in which United States persons directly or indirectly have more than a 50 per centum beneficial interest, and any corporation in which one or more United States persons, directly or indirectly, own stock possessing more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock.

The term **"acting on behalf of or in conjunction with"** in reference to a foreign person means obtaining credit for the purpose of purchasing or carrying a security in which, or in the income or gains or losses from which, a United States person or a foreign person controlled by a United States person has a substantial direct or indirect beneficial interest. Absent these factors the term does not include an interest derived solely from the ownership of less than 50 per cent of the outstanding capital stock issued by such foreign person who is obtaining such credit.

The term **"obtain credit"** means to obtain, receive, or enjoy the beneficial use of credit.

The term **"United States"** includes any State of the United States, the District of Columbia, Puerto Rico, the Canal Zone, the Virgin Islands, or any other possession of the United States.

The term **"lender"** means a person who in the ordinary course of his business extends, maintains, or arranges for credit, including a G-lender, a broker/dealer, a bank, and a foreign lender.

The term **"G-lender"** means a person who is not a broker/dealer or bank, who in the ordinary course of his business extends, maintains, or arranges credit that is secured, directly or indirectly, in whole or in part, by collateral that includes any margin securities, and who is subject to the registration requirement of section 207.1(a) of Part 207 (Regulation G).

The term **"bank"** means a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, including a foreign branch of a bank, except that such term does not include a bank which is a member of a national securities exchange, a foreign affiliate of a bank, or a foreign bank.

The term **"foreign lender"** means a person, other than a United States person, who in the ordinary course of his business extends, maintains, or arranges purpose credit outside the United States and who is not a foreign branch or subsidiary of a broker/dealer, a foreign branch of a bank, or a foreign branch of a G-lender.

The term **"arranging for credit"** refers to any activity in relation to the credit absent which the credit would not be obtained or any participation indispensable and necessary to the completion of the credit transaction.

REGULATION G

(12 CFR 207)

As amended effective March 30, 1971

SECURITIES CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS *

SECTION 207.1—GENERAL RULE

(a) **Registration.** Every person who, in the ordinary course of his business,[1] during any calendar quarter ended after October 20, 1967, extends or arranges for the extension of a total of $50,000 or more or has outstanding at any time during the calendar quarter, a total of $100,000 or more, in credit, secured directly or indirectly,[2] in whole or in part, by collateral that includes any margin securities,[3] unless such person is subject to Part 220 (Regulation T) or Part 221 (Regulation U) of this Chapter, is subject to the registration requirements of this paragraph and shall, within 30 days following the end of the calendar quarter during which the person becomes subject to such registration requirements, register with the Board of Governors of the Federal Reserve System by filing a statement in conformity with the requirements of Federal Reserve Form G-1 with the Federal Reserve Bank of the district in which the principal office of such person is located: *Provided*, That in the case of credit so secured by collateral that includes any OTC margin stock[4] and/or debt securities convertible into OTC margin stock and no other margin security, such date shall be July 8, 1969, instead of October 20, 1967.

(b) **Termination of registration.** Any person so registered who has not, during the preceding 6 calendar months, extended or arranged for the extension or maintenance of or had outstanding any credit secured directly or indirectly, in whole or in part, by collateral that includes any margin securities may apply for termination of such registration by filing Federal Reserve Form G-2 with the Federal Reserve Bank of the district in which the principal office of such person is located. A registration shall be deemed terminated when such application is approved by the Board of Governors of the Federal Reserve System.

(c) **Definition of lender and applicability of margin requirements.** Any person subject to the registration requirements of paragraph (a) of this section who, in the ordinary course of his business, extends or maintains or arranges for the extension or maintenance of any credit for the purpose of purchasing or carrying any margin security (hereinafter called

* This text corresponds to the Code of Federal Regulations, Title 12, Chapter II, Part 207, cited as 12 CFR 207. The words "this part" as used herein, mean Regulation G.

[1] See § 207.2(b).

[2] See § 207.2(*i*).

[3] See § 207.2(d).

[4] See § 207.2(f). "OTC stock" is stock which is traded "over the counter."

"purpose credit"), if such credit is secured directly or indirectly, in whole or in part, by collateral that includes any such security, is a **"lender"** subject to this part and shall not after February 1, 1968, except as provided in § 207.4(a), extend or arrange for the extension of any purpose credit in an amount exceeding the maximum loan value of the collateral, as prescribed from time to time for margin securities in § 207.5 (the Supplement to Regulation G), or as determined by the lender in good faith for any collateral other than margin securities: *Provided,* That credit extended before July 8, 1969, for the purpose of purchasing or carrying OTC margin stock and/or debt securities convertible into such stock shall not be deemed to be purpose credit: *And provided further,* That any collateral consisting of convertible securities described in paragraph (d) of this section shall have loan value only as provided in that paragraph.

(d) **Credit on convertible debt securities.** (1) A lender may extend credit for the purpose specified in paragraph (c) of this section on collateral consisting of any debt security (i) convertible with or without consideration, presently or in the future, into a margin security or (ii) carrying any warrant or right to subscribe to or purchase such a margin security (such a convertible debt security is sometimes referred to herein as a "convertible security").

(2) Credit extended under this paragraph shall be subject to the same conditions as any other credit subject to this section except: (i) the entire amount of such credit shall be considered a single credit treated separately from the single credit specified in paragraph (g) of this section and all the collateral securing such credit shall be considered in determining whether or not the credit complies with this part, and (ii) the maximum loan value of the collateral shall be as prescribed from time to time in § 207.5(b) (the Supplement to Regulation G).

(3) Any convertible security originally eligible as collateral for credit extended under this paragraph shall be treated as such as long as continuously held as collateral for such credit even though it ceases to be convertible or to carry warrants or rights.

(4) In the event that any margin security other than a convertible security is substituted for a convertible security held as collateral for credit extended under this section, such margin security and any credit extended on it in compliance with this part shall thereupon be treated as subject to paragraph (c) of this section and not to this paragraph and the credit extended under this paragraph shall be reduced by an amount equal to the maximum loan value of the security withdrawn.

(e) **Statements as to purpose of credit.** (1) In connection with any extension of credit secured directly or indirectly, in whole or in part, by collateral that includes any margin security, every person who is subject to the registration requirement of paragraph (a) of this section shall, prior to such extension, obtain a statement in conformity with the requirements of Federal Reserve Form G-3 executed by the customer and executed and accepted in good faith by such person. Such person shall retain such statement in his records for at least 3 years after such credit is extinguished. In determining whether credit is "purpose credit", such person may rely on the statement executed by the customer if accepted in good faith. To accept the customer's statement in good faith, such person must (i) be alert to the circumstances surrounding the credit and (ii) if he has any further information which would cause a prudent man not to accept the statement without inquiry, have investigated and be satisfied that the customer's statement is truthful.

(2) Circumstances which could indicate that such person has not exercised reasonable diligence in so investigating and so satisfying himself would include, but are not limited to, facts such as that (i) the proceeds of the credit were paid to a broker or to a bank in connection with contemporaneous delivery of margin securities, whether or not payment was made against delivery, (ii) there were frequent substitutions of margin securities serving as collateral for the credit, or (iii) the amount of the credit was disproportionate, or the terms inappropriate, to the stated purpose.

(f) **Credit extended to person subject to Regulation T.** (1) No lender shall extend or maintain any credit for the purpose of purchasing or carrying any margin security to any customer who is subject to Part 220 of this Chapter (Regulation T) without collateral or on collateral consisting of margin securities (other than exempted securities [5]). Where the credit is to be used in the ordinary course of business of such customer, such credit is presumed to be for the purpose of purchasing or carrying margin securities unless the lender has in his records a statement to the contrary obtained and executed in conformity with the requirements of paragraph (e) of this section.

(2) The prohibition of this paragraph (f) shall not apply to credit which is unsecured or secured by

[5] As defined in 15 U.S.C. 78c(a)(12).

collateral other than margin securities, and which is (i) made to a dealer[6] to aid in the distribution of securities to customers not through the medium of a national securities exchange, or (ii) subordinated to the claims of general creditors by a subordination agreement approved by an appropriate committee of a national securities exchange or by a "satisfactory subordination agreement" as defined in paragraph (c)(7) of Rule 15c3-1 of the Securities and Exchange Commission (17 CFR 240.15c3-1(c)(7)).

(3) The Board of Governors of the Federal Reserve System may by Order exempt from the prohibitions of this paragraph (f) and the requirements of this part, either unconditionally or upon specified terms and conditions or for stated periods, any loan for the purpose of making a loan or providing capital to a person who is subject to Part 220 of this Chapter (Regulation T), upon a finding that the granting of such an exemption is necessary or appropriate, in the public interest or for the protection of investors; *Provided*, That the Securities Investor Protection Corporation shall have certified to the Board that such action is appropriate under the circumstances.

(g) **Combining purpose credit extended to the same customer.** For the purpose of this part, except for a credit subject to paragraph (d) of this section and § 207.4(a)(2), the aggregate of all outstanding purpose credit extended to a customer by a lender after February 1, 1968, shall be considered a single credit and, except as provided in paragraphs (d) and (i) of this section, all the collateral securing such a credit, whether directly or indirectly, in whole or in part, shall be considered in determining whether the credit complies with this part.

(h) **Purpose and nonpurpose credit extended to the same person.** No lender shall after February 1, 1968, extend or arrange for the extension of any purpose credit, or maintain or arrange for the maintenance of any purpose credit extended after February 1, 1968, if the credit is secured directly or indirectly, in whole or in part, by collateral that includes any margin security which also secures, directly or indirectly, in whole or in part, any other credit in excess of $5,000 extended to the same customer after February 1, 1968; and no lender shall have outstanding at the same time to the same customer both such purpose credit and any such other credit: *Provided*, That the prohibitions of this paragraph shall not apply to (i) credit extended for the purpose of purchasing, constructing, maintaining, or improving a dwelling which is occupied or to be occupied by the customer as his principal residence when such credit is secured by a first lien on such dwelling; or (ii) credit secured by a share account or other claim acquired by the customer from the lender independently of the credit and payable (or entitling the holder to a loan thereon) in a dollar amount determined without regard to the market value of the assets supporting the claim.

[6] As defined in 15 U.S.C. 78c(a)(5).

(i) **Purpose credit secured both by margin securities and by other collateral.** In the case of any purpose credit extended or arranged after February 1, 1968, secured directly or indirectly, in whole or in part, by any margin security, no other collateral shall have any loan value in respect to such credit for the purpose of this part: *Provided, however,* That a share account or other claim acquired by the customer from the lender independently of the credit and payable (or entitling the holder to a loan thereon) in a dollar amount determined without regard to the market value of the assets supporting the claim shall have a maximum loan value as determined by the lender in good faith.

(j) **Withdrawals and substitutions of collateral.** (1) *General rule.* Except as permitted by the next subparagraph and by § 207.4(a), while a lender maintains any purpose credit extended after February 1, 1968, the lender shall not at any time permit any withdrawal or substitution of collateral unless either (i) the credit would not exceed the maximum loan value of the collateral after such withdrawal or substitution, or (ii) the credit is reduced by at least the amount by which the maximum loan value of any collateral deposited is less than the "retention requirement" of any collateral withdrawn. The retention requirement of collateral other than margin securities is the same as its maximum loan value and the retention requirement of collateral consisting of margin securities or debt securities convertible into margin securities is prescribed from time to time in § 207.5 (the Supplement to Regulation G).

(2) *Same-day substitution of collateral.* Except as prohibited by § 207.4(a) a lender may permit a substitution of margin securities effected by a purchase and sale on orders executed within the same day: *Provided*, That (i) if the proceeds of the sale exceed the total cost of the purchase, the credit is reduced by at least an amount equal to the retention requirement in respect to the sale less the retention requirement in respect to the purchase, or (ii) if the total cost of the purchase exceeds the proceeds of the sale, the credit may be increased by an

amount no greater than the maximum loan value of the securities purchased less the maximum loan value of the securities sold. If the maximum loan value of the collateral securing the credit has become less than the amount of the credit, the amount of the credit may nonetheless be increased if there is provided additional collateral having maximum loan value at least equal to the amount of increase, or the credit is extended pursuant to § 207.4(a).

SECTION 207.2—DEFINITIONS

For the purpose of this part, unless the context otherwise requires:

(a) Terms herein have the meanings given them in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

(b) The term **"in the ordinary course of his business"** means occurring or reasonably expected to occur from time to time in the course of any activity of a person for profit or the management and preservation of property or in addition, in the case of a person other than an individual, carrying out or in furtherance of any business purpose.

(c) The **"purpose"** of a credit is determined by substance rather than form.

(1) Credit which is for the purpose, whether immediate, incidental, or ultimate, of purchasing or carrying a margin security is "purpose credit", despite any temporary application of funds otherwise.

(2) Credit to enable the customer to reduce or retire indebtedness which was originally incurred to purchase a margin security is for the purpose of "carrying" such a security.

(3) An extension of credit provided for in a plan, program, or investment contract offered or sold or otherwise initiated after August 31, 1969, which provides for the acquisition both of any securities described in paragraph (d) of this section and of goods, services, property interests, other securities, or investments, is "purpose credit."

(d) **Margin security.** The term "margin security" means any equity security[7] which is (1) a registered equity security, (2) an OTC margin stock, (3) a debt security (i) convertible with or without consideration, presently or in the future, into a margin security, or (ii) carrying any warrant or right to subscribe to or purchase, presently or in the future, a margin security, (4) any such warrant or right, (5) a security issued by an investment company, other than a small business investment company licensed under the Small Business Investment Company Act of 1958 (15 U.S.C. 661), registered pursuant to section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), unless at least 95 per cent of the assets of such company are continuously invested in exempted securities.[8]

(e) **Registered equity security.** The term "registered equity security" means any equity security which (1) is registered on a national securities exchange, (2) has unlisted trading privileges on a national securities exchange, or (3) is exempted by the Securities and Exchange Commission from the operation of section 7(c)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78g(c)(2)) only to the extent necessary to render lawful any direct or indirect extension or maintenance of credit on such security.

(f) **OTC margin stock.** (1) The term "OTC margin stock" means stock not traded on a national securities exchange which the Board of Governors of the Federal Reserve System has determined to have the degree of national investor interest, the depth and breadth of market, the availability of information respecting the stock and its issuer, and the character and permanence of the issuer to warrant subjecting such security to the requirements of this part.

(2) The Board will from time to time publish a list of OTC margin stocks as to which the Board has made the determinations described in subparagraph (1) of this paragraph (f). Except as provided in subparagraph (4) of this paragraph (f), such stocks shall meet the requirements of § 207.5(d) (the Supplement to Regulation G).

(3) The Board shall from time to time remove from the list described in subparagraph (2) of this paragraph (f) stocks that cease to:

(i) Exist or of which the issuer ceases to exist, or

(ii) Meet substantially the provisions of subparagraph (1) of this paragraph (f) and § 207.5(d) (the Supplement to Regulation G).

(4) The foregoing notwithstanding, the Board may, upon its own initiative, or upon application by any interested party, omit or remove any stock that is not traded on a national securities exchange from or add any such stock to such list of OTC margin stocks, if in the judgment of the Board such action is necessary or appropriate in the public interest.

(5) It shall be unlawful for any person to make, or cause to be made, any representation to the effect that the inclusion of a security on such list of OTC margin stocks is evidence that the Board or the Securities and Exchange Commission has in any way passed upon the merits of, or given approval to,

[7] As defined in 15 U.S.C. 78c(a)(11).

[8] As defined in 15 U.S.C. 78c(a)(12).

such security or any transaction therein. Any statement in an advertisement or other similar communication containing a reference to the Board in connection with such stocks or such list shall constitute such an unlawful representation.

(g) **Purchase and sale.** (1) The term "purchase" includes any contract to buy, purchase, or otherwise acquire.

(2) The term "sale" includes any contract to sell or otherwise dispose of.

(h) The term **"customer"** includes any recipient of the credit to whom credit is extended directly or indirectly for the use of the customer, and also includes any person engaged in a joint venture, or as a member of a syndicate or a group, with the customer with respect to a purpose loan.

(i) The term **"indirectly secured"** includes, except as provided in § 207.4(a)(3), any arrangement with the customer under which the customer's right or ability to sell, pledge, or otherwise dispose of margin securities owned by the customer is in any way restricted as long as the credit remains outstanding, or under which the exercise of such right, whether by written agreement or otherwise, is or may be cause for acceleration of the maturity of the credit: *Provided,* That the foregoing shall not apply (1) if such restriction arises solely by virtue of an arrangement with the customer which pertains generally to the customer's assets unless a substantial part of such assets consists of margin securities, or (2) if the lender in good faith has not relied upon such securities as collateral in the extension or maintenance of the particular credit: *And provided further,* That the foregoing shall not apply to stock held by the lender only in the capacity of custodian, depositary, or trustee, or under similar circumstances, if the lender in good faith has not relied upon such securities as collateral in the extension or maintenance of the particular credit.

(j) The term **"stock"** includes any security commonly known as a stock; any voting trust certificate or other instrument representing such a security; any security convertible with or without consideration into such security, certificate, or other instrument, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right.

SECTION 207.3—REPORTS AND RECORDS

(a) Every person who is registered pursuant to § 207.1(a) of this part shall within 30 days following the end of each succeeding calendar quarter file a report on Federal Reserve Form G-4 with the Federal Reserve Bank of the district in which the principal office of the lender is located.

(b) Every person who has registered pursuant to § 207.1(a) of this part shall maintain such records as shall be prescribed by the Board of Governors of the Federal Reserve System to enable it to perform the functions conferred upon it by the Securities Exchange Act of 1934 (15 U.S.C. 78).

SECTION 207.4—MISCELLANEOUS PROVISIONS

(a) **Stock option and employee stock purchase plans.** In respect to any credit extended and maintained by a corporation, by a lender wholly controlled and (except in the case of a lender formed prior to February 1, 1968, or a trustee) wholly owned by such corporation, or by a lender which is a membership thrift organization whose membership is limited to employees and former employees of such corporation, its subsidiaries, or affiliates (such corporations and such lenders are both sometimes referred to as "plan-lenders"), to an officer or employee of the corporation, subsidiary, or affiliate thereof to finance the exercise of rights granted such officer or employee under a stock option plan or employee stock purchase plan adopted by the corporation and approved by a majority of its stockholders to purchase margin securities of such corporation, subsidiary, or affiliate,

(1) Sections 207.1(c), (d), (f), (g), (h), (i), and (j) of this part shall not apply (i) to any such credit extended to finance the exercise of such rights granted to any named officer or employee prior to February 1, 1968 and effectively exercised by such officer or employee prior to February 1, 1969 (with respect to credit extended to purchase OTC margin stock or debt securities convertible into such stock, such dates shall be July 8, 1969, and July 8, 1970, respectively), (ii) to any credit extended prior to February 1, 1969, to a plan-lender pursuant to a *bona fide* written commitment in existence on February 1, 1968, to finance the exercise of such rights and by such plan-lender from the proceeds of such credit to any officer or employee to finance the exercise of rights granted pursuant to a stock purchase plan under which the exercise price does not exceed 50 per cent of the market value of the stock subject to purchase, valued as of the offering date thereof, or (iii) to any credit extended by a plan-lender pursuant to a stock purchase plan or stock option which is qualified or restricted under Internal Revenue

Code §§ 422, 423, or 424, to finance the exercise of such rights granted prior to February 1, 1968.

(2) The restrictions imposed by § 207.1(c) and (d) and § 207.5 (the Supplement to Regulation G) on the maximum loan value of margin securities serving as collateral for purpose credit shall not apply to securities purchased, and serving as direct or indirect collateral for credit extended, pursuant to such a plan: *Provided*, That

(i) The entire amount of credit extended to any officer or employee pursuant to this subparagraph (2) in connection with the exercise of rights under such plan or plans shall be considered a single credit;

(ii) At the time when credit is extended in connection with a plan subject to this subparagraph, (*a*) the plan-lender computes the "deficiency"—the amount by which the credit exceeds the maximum loan value of the collateral as prescribed by § 207.5 (the Supplement to Regulation G), and (*b*) the agreement under which the credit is extended provides that, except as permitted by the proviso in subdivision (iii) of this subparagraph, the officer or employee shall, in respect to such deficiency, for at least 3 years from the extension of the credit, make equal repayments to the plan-lender at least quarterly and equivalent to at least 20 per cent of such deficiency per annum, or such lesser amount as the Board of Governors of the Federal Reserve System, upon application, may permit;

(iii) The officer or employee is not permitted under such plan or credit agreement to sell, withdraw, pledge, or otherwise dispose of all or any part of such collateral until (*a*) all repayments have been made for at least the 3-year period provided in subdivision (ii) of this subparagraph and the deficiency has been repaid, or (*b*) as a result of the repayments described in subdivision (ii) of this subparagraph, and/or of a change in the current market value of the collateral, the maximum loan value of the collateral, as prescribed by § 207.5 (the Supplement to Regulation G), is at least equal to the credit which remains owing from the officer or employee to the plan-lender, whichever shall occur first: *Provided*, That this restriction need not apply where such collateral is required to be sold to meet emergency expenses arising from circumstances not reasonably foreseeable at the time of the extension of the credit (for this purpose such emergency expenses shall include the death, disability, or involuntary termination of employment of the officer or employee or some other change in his circumstances, involving extreme hardship, not reasonably foreseeable at the time the credit is extended. The opportunity to realize monetary gain is not a "change in his circumstances" for this purpose); and

(iv) At such time as either of the conditions with respect to sale, withdrawal, pledge, or other disposition of collateral specified in subdivision (iii) of this subparagraph are satisfied the credit is thereafter treated as a credit subject to all the requirements of this part.

(3) No extension of credit to a plan-lender to finance such a plan shall be deemed to be indirectly secured by a margin security purchased pursuant to the plan: *Provided*, That such security is not repledged by the plan-lender to secure such extension of credit to the plan-lender and in no event does the person extending such credit have recourse to such security: *And provided further*, That the amount of the credit does not exceed the total amount of credit currently extended by such plan-lender pursuant to such plan.

(b) **Extensions and renewals.** The renewal or extension of maturity of a credit need not be treated as the extension of a credit if the amount of the credit is not increased except by the addition of interest or service charges on the credit or of taxes on transactions in connection with the credit.

(c) **Reorganization or recapitalization.** Nothing in this part shall be construed to prohibit withdrawal or substitution of securities to enable a customer to participate in a reorganization or recapitalization.

(d) **Mistakes in good faith.** Failure to comply with this part due to a mechanical mistake made in good faith in determining, recording, or calculating any credit, balance, market price, or loan value, or other similar mechanical mistake, shall not constitute a violation of this part if promptly after discovery of the mistake the lender takes whatever action is practicable to remedy the noncompliance.

(e) **Arranging for credit.** A lender may arrange for the extension or maintenance of credit by any person upon the same terms and conditions as those upon which the lender, under the provisions of this part, may himself extend or maintain such credit, but only upon such terms and conditions, except that this limitation shall not apply with respect to the arranging by a lender for a bank subject to Part 221 of this Chapter (Regulation U) to extend or maintain credit on margin securities or exempted securities.

(f) **Combined purchase of mutual funds and insurance.** (1) An extension of purpose credit provided for in a plan, program, or investment

contract that is registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77) and provides for the acquisition both of a security issued by an investment company described in § 207.2(d)(5) and of an insurance policy or contract shall be subject to all the provisions of this part, except that, where the credit is secured by the security and does not exceed the premium on such policy (plus any applicable interest), the maximum loan value of such security shall be 40 per cent of its current market value, as determined by any reasonable method.

(2) Sections 207.1(c), (d), (f), (g), (h), (i), and (j) of this part shall not apply to any credit extended to a person registered pursuant to § 207.1(a) who extends credit pursuant to subparagraph (1) of this paragraph, *Provided,* That:

(i) the credit extended pursuant to this subparagraph is secured by securities that are issued by an investment company described in § 207.2(d)(5), and are carried for the account of one or more customers under a plan, program, or investment contract described in subparagraph (1) of this paragraph (and the person extending such credit receives written notice from the recipient of the credit to this effect); and

(ii) the provisions of such plan, program, or investment contract conform to the provisions of Rule 15c2-1 of the Securities and Exchange Commission concerning hypothecation of customers' securities (17 CFR 240.15c2-1).

[SECTION 207.5—SUPPLEMENT, containing maximum loan values, retention requirement, and requirements for inclusion on list of OTC margin stock, is printed separately.]

F. R. Form G-3
Rev. 6-69

SPECIMEN ONLY

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENT OF PURPOSE OF AN EXTENSION OF CREDIT SECURED BY MARGIN SECURITIES BY A PERSON SUBJECT TO REGISTRATION UNDER REGULATION G (FEDERAL RESERVE FORM G-3)

A FALSE OR DISHONEST STATEMENT ON THIS FORM MAY BE PUNISHABLE BY FINE OR IMPRISONMENT (U.S. CODE, TITLE 15, SECTION 78ff AND TITLE 18, SECTION 1001)

Instructions:

(1) Please print or type (if space is inadequate attach separate sheet).
(2) The term "margin security" is defined in § 207.2(d) of Regulation G. See also § 207.2(e).
(3) Part I (3) and (4) need be filled in only if the purpose of the credit described in Part I (1) is other than to purchase or carry margin securities.
(4) In Part II "source of valuation" need be filled in only if such source is other than regularly published information in journal of general circulation.
(5) Part II need not be completed in the case of a credit of $5,000 or less which is not for the purpose of purchasing or carrying margin securities. However, in such cases, Part I must be completed as if Part II were completed.

PART I (to be completed by customer(s))

(1) The purpose of this credit in the amount of $ ...., secured in whole or in part by the margin securities listed in Part II (A) and (B) is (describe in detail) ....

....

....

....

(2) .... (Name of person extending credit), has outstanding, or has agreed to extend, to the undersigned, the following credits in addition to the credit described on this form (itemize and describe briefly, including amounts and collateral if any). If none, so state ....

....

(3) Is any of the collateral listed in Part II (A) or (B) to be delivered, or has any such collateral been delivered, from a bank, broker, dealer, or person other than the undersigned? Yes ☐ No ☐

If yes, from whom? .... Against payment? Yes ☐ No ☐

(4) Has any of the collateral listed in Part II (A) or (B) been owned less than six months? Yes ☐ No ☐ If yes, identify all such collateral so owned. ....

....

The undersigned has (have) read this form and hereby certifies and affirms that to the best of my (our) knowledge and belief the information contained therein is true, accurate, and complete.

SIGNED .... (Manual signature) (Date) SIGNED .... (Manual signature) (Date)

.... (Print or type name) .... (Print or type name)

PART II (to be completed by person extending credit)

(A) Collateral consisting of margin securities, other than debt securities convertible into margin securities. The loan value of such securities under the current Supplement to Regulation G is .... per cent.

No. of shares	Itemize separately by issue	Market price per share	Source of valuation	Total market price per issue

(B) Collateral consisting of debt securities convertible into margin securities. The loan value of such securities under the current Supplement to Regulation G is .... per cent.

Par value	Itemize separately by issue	Market price	Source of valuation	Total market price per issue

(C) Other collateral.

Describe briefly (itemize where 10 per cent or more)	Market value	Source of valuation	Good faith loan value

The undersigned, a person subject to registration under Regulation G, is aware that this credit secured by margin securities may be subject to Regulation G, has read this form, has accepted the customer's statement on Part I in good faith as defined below*, and hereby certifies and affirms that to the best of his knowledge and belief all the information contained therein is true, accurate, and complete.

Date .... SIGNED ....

(Manual signature)

....

(Print or type name and title)

* Regulation G requires that the customer's statement on this form be accepted by the person extending the credit in good faith. Good faith requires that such person (1) must be alert to the circumstances surrounding the credit, and (2) if he has any information which would cause a prudent man not to accept the statement without inquiry, has investigated and is satisfied that the statement is truthful. Among the facts which would require such investigation are receipt of the statement through the mail or from a third party.

THIS FORM MUST BE RETAINED BY THE PERSON EXTENDING THE CREDIT FOR AT LEAST THREE YEARS AFTER THE TERMINATION OF THIS CREDIT

REGULATION T

(12 CFR 220)

As amended effective May 15, 1970

CREDIT BY BROKERS AND DEALERS *

SECTION 220.1—SCOPE OF PART

This part is issued by the Board of Governors of the Federal Reserve System (hereinafter called the "Board") pursuant to the Securities Exchange Act of 1934 (called the "Act" in this part), particularly sections 7 and 8(a) thereof (15 U.S.C. 78g, 78h(a), as amended), and applies to every broker or dealer, including every member of a national securities exchange.

SECTION 220.2—DEFINITIONS

For the purposes of this part, unless the context otherwise requires:

(a) The terms herein have the meanings given them in section 3(a) of the Act (15 U.S.C. 78c(a)).

(b) The term **"creditor"** means any broker or dealer including every member of a national securities exchange.

(c) The term **"customer"** (1) includes any person, or any group of persons acting jointly, (i) to or for whom a creditor is extending, arranging, or maintaining any credit, or (ii) who, in accordance with the ordinary usage of the trade, would be considered a customer of the creditor, and (2) includes, but is not limited to (i) in case the creditor is a firm, any partner in the firm who would be considered a customer of the firm if he were not a partner, and (ii) any joint venture in which a creditor participates and which would be considered a customer of the creditor if the creditor were not a participant.

(d) The term **"registered security"** means any security which (1) is registered on a national securities exchange; or (2) in consequence of its having unlisted trading privileges on a national securities exchange is deemed, under the provisions of section 12(f) of the Act (15 U.S.C. 78*l*), to be registered on a national securities exchange; or (3) is exempted by the Securities and Exchange Commission from the operation of section 7(c)(2) of the Act (15 U.S.C. 78g(c)(2)) only to the extent necessary to render lawful any direct or indirect extension or maintenance of credit on such security or any direct or indirect arrangement therefor which would not have been unlawful if such security had been a security (other than an exempted security) registered on a national securities exchange.

(e) (1) The term **"OTC margin stock"** [1] means stock not traded on a national securities exchange which the Board of Governors of the Federal Re-

* This text corresponds to the Code of Federal Regulations, Title 12, Chapter II, Part 220, cited as 12 CFR 220. The words "this part," as used herein, mean Regulation T.

[1] "OTC stock" hereinafter refers to stock traded "over the counter."

serve System has determined to have the degree of national investor interest, the depth and breadth of market, the availability of information respecting the stock and its issuer, and the character and permanence of the issuer to warrant subjecting such stock to the requirements of this part.

(2) The Board will from time to time publish a list of OTC margin stock as to which the Board has made the determinations described in subparagraph (1) of this paragraph (e). Except as provided in subparagraph (4) of this paragraph (e), such stocks shall meet the requirements of § 220.8 (g) (the Supplement to Regulation T).

(3) The Board will from time to time remove from the list described in subparagraph (2) of this paragraph (e) stocks that cease to:

(i) Exist or of which the issuer ceases to exist, or

(ii) Meet substantially the provisions of subparagraph (1) of this paragraph (e) and of § 220.8 (g) (the Supplement to Regulation T).

(4) The foregoing notwithstanding, the Board may, upon its own initiative or upon application by any interested party, omit or remove any stock that is not traded on a national securities exchange from or add any such stock to such list of OTC margin stocks if in the judgment of the Board, such action is necessary or appropriate in the public interest.

(5) It shall be unlawful for any creditor to make, or cause to be made, any representation to the effect that the inclusion of a security on such list of OTC margin stocks is evidence that the Board or the Securities and Exchange Commission has in any way passed upon the merits of, or given approval to, such security or any transaction therein. Any statement in an advertisement or other similar communication containing a reference to the Board in connection with such stocks or such list shall constitute such an unlawful representation.

(f) The term **"margin security"** means any registered security or OTC margin stock.

(g) The term **"exempted security"** has the meaning given it in section 3(a) of the Act (15 U.S.C. 78c(a)(12)), except that the term does not include a security which is exempted by the Securities and Exchange Commission from the operation of section 7(c)(2) of the Act (15 U.S.C. 78g(c)(2)) only to the extent described in paragraph (d)(3) of this section.

(h) The term **"non-equity security"** means any security other than an equity security[2] or an exempted security.

[2] As defined in 15 U.S.C. 78c(a)(11).

SECTION 220.3—GENERAL ACCOUNTS

(a) **Contents of general account.** All financial relations between a creditor and a customer, whether recorded in one record or in more than one record, shall be included in and be deemed to be part of the customer's general account with the creditor, except that the relations which § 220.4 permits to be included in any special account provided for by that section may be included in the appropriate special account, and all transactions in commodities, and, except to the extent provided in paragraph (b)(2) of § 220.3, all transactions in non-equity securities, exempted securities, and in other securities having no loan value in a general account under the provisions of § 220.3(c) and § 220.8 (the Supplement to Regulation T) (except unissued securities, short sales and purchases to cover short sales, securities positions to offset short sales, contracts involving an endorsement or guarantee of any put, call, or other option), shall be included in the appropriate special account provided for by § 220.4. During any period when such § 220.8 specifies that margin equity securities shall have no loan value in a general account or special convertible debt security account (sometimes referred to herein as "special convertible security account") subject to § 220.4(j), any transaction consisting of a purchase of a security other than a purchase of a security to reduce or close out a short position shall be effected in the special cash account provided for by § 220.4(c) or in some other appropriate special account provided for by § 220.4.

(b) **General rule.** (1) A creditor shall not effect for or with any customer in a general account, special bond account subject to § 220.4(i), or special convertible security account any transaction which, in combination with the other transactions effected in such account on the same day, creates an excess of the adjusted debit balance of such account over the maximum loan value of the securities in such account, or increases any such excess, unless in connection therewith the creditor obtains, as promptly as possible and in any event before the expiration of 5 full business days following the date of such transaction, the deposit into such account of cash or securities in such amount that the cash deposited plus the loan value of the securities deposited equals or exceeds the excess so created or the increase so caused.

(2) Except as permitted in this subparagraph, no withdrawal of cash or exempted or margin securities shall be permissible if the adjusted debit balance of the account (whether the general account, the special bond account, or the special convertible security account) would exceed the maximum loan value of the securities in such account after such withdrawal. The exceptions are available only in the event no cash or securities need to be deposited in such account in connection with a transaction on a previous day and none would need to be deposited thereafter in connection with any withdrawal of cash or securities on the current day. The permissible exceptions are (i) registered non-equity securities or exempted securities held in the general account on March 11, 1968, and continuously thereafter may be withdrawn upon the deposit in the account of cash (or margin equity securities counted at their maximum loan value) at least equal to the "retention requirement" of such withdrawn securities, or (ii) except as provided in (i) of this subparagraph, securities having loan value in the general account, the special bond account, or the special convertible security account may be withdrawn upon the deposit in such account of cash or securities having loan value in such account counted at the maximum loan value at least equal to the "retention requirement" of those securities, or (iii) cash may be withdrawn upon the deposit in the general account, the special bond account, or the special convertible security account of securities having a maximum loan value in such account at least equal to the amount of cash withdrawn, or (iv) upon the sale (other than the short sale) of securities having loan value in the general account, special bond account, or special convertible security account there may be withdrawn in cash an amount equal to the difference between the current market value of the securities sold and the "retention requirement" of such securities, or (v) upon the sale (other than the short sale) of a registered non-equity security or an exempted security that was held in the general account on March 11, 1968, and continuously thereafter there may be withdrawn in cash an amount equal to the difference between the current market value of the securities sold and the "retention requirement" of those securities as prescribed in § 220.8 (the Supplement to Regulation T).

(3) Rules for computing the maximum loan value of the securities in a general account, special bond account, or special convertible security account and the adjusted debit balance of such account are provided in paragraphs (c) and (d) of this section, and certain modifications of and exceptions to the general rule stated in this paragraph are provided in the subsequent paragraphs of this section and in § 220.6.

(c) **Maximum loan value and current market value.** (1) The maximum loan value of the securities in a general account, special bond account, or special convertible security account is the sum of the maximum loan values of the individual securities in such account, including securities (other than unissued securities) bought for such account but not yet debited thereto, but excluding securities sold for such account whether or not payment has been credited thereto.

(2) Except as otherwise provided in this paragraph, the maximum loan value of a security in a general account, special bond account, or special convertible security account shall be such maximum loan value as the Board shall prescribe from time to time in § 220.8 (the Supplement to Regulation T). No collateral other than an exempted security or a registered non-equity security held in such account on March 11, 1968, and continuously thereafter, or margin equity security shall have any loan value in a general account except that a margin equity security eligible for a special convertible security account pursuant to § 220.4(j) shall have loan value in a general account only if held in the account on March 11, 1968, and continuously thereafter.

(3) A warrant or certificate which evidences only a right to subscribe to or otherwise acquire any security and which expires within 90 days of issuance shall have no loan value in a general account, special bond account, or special convertible security account; but, if the account contains the security to the holder of which such warrant or certificate has been issued and such warrant or certificate is held in an appropriate account maintained by the creditor for the customer the current market value of such security (if such security is a margin security) shall, for the purpose of calculating its maximum loan value, be increased by the current market value of such warrant or certificate.

(4) For the current market value of a security throughout the day of its purchase or sale, the creditor shall use its total cost or the net proceeds of its sale, as the case may be, and at any other

time shall use the closing sale price of the security on the preceding business day as shown by any regularly published reporting or quotation service. In the absence of any such closing sale price, the creditor may use any reasonable estimate of the market value of such security as of the close of business on such preceding business day.

(d) **Adjusted debit balance.** For the purpose of this part, the adjusted debit balance of a general account, special bond account, or special convertible security account shall be calculated by taking the sum of the following items:

(1) the net debit balance, if any, of such account;

(2) the total cost of any securities (other than unissued securities) bought for such account but not yet debited thereto;

(3) the current market value of any securities (other than unissued securities) sold short in the general account plus, for each security (other than an exempted security), such amount as the Board shall prescribe from time to time in § 220.8 (the Supplement to Regulation T) as the margin required for such short sales, except that such amount so prescribed in such § 220.8 need not be included when there are held in the general account the same securities or securities exchangeable or convertible within 90 calendar days, without restriction other than the payment of money, into such securities sold short;

(4) the amount of margin specified by paragraph (h) of this section for every net commitment in such account in unissued securities, plus all unrealized losses on each commitment in unissued securities and minus all unrealized gains (not exceeding the required margin) on each commitment in unissued securities; and

(5) the amount of any margin customarily required by the creditor in connection with his endorsement or guarantee of any put, call, or other option;

and deducting there from the sum of the following items:

(6) the net credit balance, if any, of such account; and

(7) the net proceeds of sale of any securities (other than unissued securities) sold for such account but for which payment has not yet been credited thereto.

In case such account is the account of a partner of the creditor or the account of a joint venture in which the creditor participates, the adjusted debit balance shall be computed according to the foregoing rule and the supplementary rules prescribed in § 220.6(a) and (b).

(e) **Liquidation in lieu of deposit.**[5] In any case in which the deposit required by paragraph (b) of this section, or any portion thereof, is not obtained by the creditor within the 5-day period specified therein, margin non-exempted securities shall be sold (or, to the extent that there are insufficient margin non-exempted securities in the general account, special bond account, or special convertible security account other liquidating transactions shall be effected in such account), prior to the expiration of such 5-day period, in such amount that the resulting decrease in the adjusted debit balance of such account exceeds, by an amount at least as great as such required deposit or the undeposited portion thereof, the "retention requirement" of any margin or exempted securities sold: *Provided*, That a creditor is not required to sell securities or to effect other liquidating transactions specified by this paragraph in an amount greater than necessary to eliminate the excess of the adjusted debit balance of such account over the maximum loan value of the securities remaining in such account after such liquidation.

(f) **Extensions of time.** In exceptional cases, the 5-day period specified in paragraph (b) of this section may, on application of the creditor, be extended for one or more limited periods commensurate with the circumstances (1) by any regularly constituted committee of a national securities exchange having jurisdiction over the business conduct of its members, of which exchange the creditor is a member or through which his transactions are effected, or (2) in instances where the procedure described above is not readily available or appropriate, by a committee of a national securities association: *Provided*, That such committee is satisfied that the creditor is acting in good faith in making the application and that the circumstances are in fact exceptional and warrant such action.

(g) **Transactions on given day.** For the purposes of paragraph (b) of this section, the question of whether or not an excess of the adjusted debit balance of a general account, special bond account, or special convertible security account over the maximum loan value of the securities in such account is created or increased on a given day shall be deter-

[5] This requirement relates to the action to be taken when a customer fails to make the deposit required by § 220.3(b), and it is not intended to countenance on the part of customers the practice commonly known as "free-riding," to prevent which the principal national securities exchanges have adopted certain rules. See the rules of such exchanges and § 220.7(e).

mined on the basis of all the transactions in the account on such day exclusive of any deposit of cash, deposit of securities, covering transaction, or other liquidation that has been effected on such day, pursuant to the requirement of paragraphs (b) or (e) of this section, in connection with a transaction on a previous day. In any case in which an excess so created, or increase so caused, by transactions on a given day does not exceed $100, the creditor need not obtain the deposit specified therefor in subparagraph (b)(1) of this section. Any transaction which serves to meet the requirements of paragraph (e) of this section or otherwise serves to permit any offsetting transaction in an account shall, to that extent, be unavailable to permit any other transaction in such account. For the purposes of this part (Regulation T)., if a security has maximum loan value under subparagraph (c)(1) of this section in a general account, a sale of the same security (even though not the same certificate) in such account shall be deemed to be a long sale and shall not be deemed to be or treated as a short sale.

(h) **Unissued securities.** (1) The amount to be included in the adjusted debit balance of a general account, special bond account, or special convertible security account as the margin required for a net long commitment in unissued securities shall be the current market value of the net amount of unissued securities long *minus* the maximum loan value which such net amount of securities would have if they were issued margin securities held in such account; and the amount to be so included as the margin required for a net short commitment in unissued securities shall be the amount which would be required as margin for the net amount of unissued securities short if such securities were issued securities and were sold short in such account: *Provided,* That no amount need be included as margin for a net short commitment in unissued securities when there are held in such account securities in respect of which the unissued securities are to be issued, nor for any net position in unissued securities that are exempted securities.

(2) Whenever a creditor, pursuant to a purchase of an unissued security for a customer, receives an issued security which is not a margin or exempted security, the creditor shall treat as the margin required for such purchase, any payment by the customer for such issued security as a transaction (other than a withdrawal) which increases the adjusted debit balance of a general account, special bond account, or special convertible security account by the amount of the payment *minus* the amount required to be included in the adjusted debit balance of such account, at the time of and in connection with the purchase of the unissued security.

SECTION 220.4—SPECIAL ACCOUNTS

(a) **General rule.** (1) Pursuant to this section, a creditor may establish for any customer one or more special accounts.

(2) Each such special account shall be recorded separately and shall be confined to the transactions and relations specifically authorized for such account by the appropriate paragraph of this section and to transactions and relations incidental to those specifically authorized. An adequate record shall be maintained showing for each such account the full details of all transactions in the account.

(3) A special account established pursuant to this section shall not be used in any way for the purpose of evading or circumventing any of the provisions of this part. If a customer has with a creditor both a general account and one or more such special accounts, the creditor shall treat each such special account as if the customer had with the creditor no general account, special bond account subject to § 220.4(i), or special convertible security account subject to § 220.4(j).

(4) The only other conditions to which transactions in such special accounts shall be subject under the provisions of this part shall be such conditions as are specified in the appropriate paragraph of this section and in §§ 220.2, 220.6, 220.7, or 220.8, except insofar as § 220.3 applies to §§ 220.4(i), and (j).

(b) **Special omnibus account.** In a special omnibus account, a member of a national securities exchange may effect and finance transactions for another member of a national securities exchange or a broker or dealer registered with the Securities and Exchange Commission under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) from whom the member receives (1) written notice, pursuant to a rule of the Securities and Exchange Commission concerning the hypothecation of customers' securities by brokers or dealers (Rule 8c-1 (17 CFR 240.8c-1) or Rule 15c2-1 (17 CFR 240.15c2-1)), to the effect that all securities carried in the account will be carried for the account of the customers of the broker or dealer and (2) written notice that any short sales effected in the account will be short sales made in behalf of the customers of the broker or dealer other than his partners. No substitutions of collateral securing credit extended to a broker or dealer not described

in the preceding sentence shall be permitted after October 6, 1969, and no such credit shall be maintained after July 8, 1970.

(c) **Special cash account.** (1) In a special cash account, a creditor may effect for or with any customer *bona fide* cash transactions in securities in which the creditor may:

(i) Purchase any security for, or sell any security to, any customer, provided funds sufficient for the purpose are already held in the account or the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment for the security and that the customer does not contemplate selling the security prior to making such payment.

(ii) Sell any security for, or purchase any security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be promptly deposited in the account.

(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3)–(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof.

(3) If the security when so purchased is an unissued security, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is made available by the issuer for delivery to purchasers. If the security when so purchased is a "when distributed" security which is to be distributed in accordance with a published plan, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is so distributed. If the security when so purchased is a new security issued or to be issued for the purpose of refunding outstanding securities which mature, or are to be payable upon presentation for redemption, within 35 days of the date on which the new security is made available by the issuer for delivery to purchasers, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after such maturity or payment date: *Provided,* That this sentence shall apply only to the payment of that portion of the purchase price that does not exceed 103 per cent of the amount that will be payable to the purchaser of the new security upon such maturity of, or payment for, securities owned by him at the time of the purchase.

(4) If any shipment of securities is incidental to the consummation of the transaction, the period applicable to the transaction under subparagraph (2) of this paragraph shall be deemed to be extended by the number of days required for all such shipments, but not by more than 7 days.

(5) If the creditor, acting in good faith in accordance with subparagraph (1) of this paragraph, purchases a security for a customer, or sells a security to a customer, with the understanding that he is to deliver the security promptly to the customer, and the full cash payment to be made promptly by the customer is to be made against such delivery, the creditor may at his option treat the transaction as one to which the period applicable under subparagraph (2) of this paragraph is not the 7 days therein specified but 35 days after the date of such purchase or sale.

(6) If an appropriate committee of a national securities exchange or a national securities association is satisfied that the creditor is acting in good faith in making the application, that the application relates to a *bona fide* cash transaction, and that exceptional circumstances warrant such action, such committee, on application of the creditor, (i) may extend any period specified in subparagraphs (2), (3), (4), or (5) of this paragraph for one or more limited periods commensurate with the circumstances, or (ii), in case a security purchased by the customer in the special cash account is a margin or exempted security, may authorize the transfer of the transaction to a general account, special bond account, special convertible security account, or special omnibus account, and the completion of such transaction pursuant to the provisions of this part relating to such an account.

(7) The 7-day periods specified in this paragraph refer to 7 full business days. The 35-day period and the 90-day period specified in this paragraph refer to calendar days, but if the last day of any such period is a Saturday, Sunday, or holiday, such period shall be considered to end on the next full business day. For the purposes of this paragraph, a creditor may, at his option, disregard any sum due by the customer not exceeding $100.

(8) Unless funds sufficient for the purpose are already in the account, no security other than an exempted security shall be purchased for, or sold to, any customer in a special cash account with the

creditor if any security other than an exempted security has been purchased by such customer in such an account during the preceding 90 days, and then, for any reason whatever, without having been previously paid for in full by the customer, the security has been sold in the account or delivered out to any broker or dealer: *Provided,* That an appropriate committee of a national securities exchange or a national securities association, on application of the creditor, may authorize the creditor to disregard for the purposes of this subparagraph any given instance of the type therein described if the committee is satisfied that both creditor and customer are acting in good faith and that circumstances warrant such authorization. For the purposes of this subparagraph, the cancelation of a transaction, otherwise than to correct an error, shall be deemed to constitute a sale. The creditor may disregard for the purposes of this subparagraph a sale without prior payment provided full cash payment is received within the period described by subparagraph (2) of this paragraph and the customer has not withdrawn the proceeds of sale on or before the day on which such payment (and also final payment of any check received in that connection) is received. The creditor may so disregard a delivery of a security to another broker or dealer provided such delivery was for deposit into a special cash account which the latter broker or dealer maintains for the same customer and in which account there are already sufficient funds to pay for the security so purchased; and for the purpose of determining in that connection the status of a customer's account at another broker or dealer, a creditor may rely upon a written statement which he accepts in good faith from such other broker or dealer.

(d) **Special arbitrage account.** In a special arbitrage account, a member of a national securities exchange may effect and finance for any customer *bona fide* arbitrage transactions in securities. For the purpose of this paragraph, the term "arbitrage" means (1) a purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable, for the purpose of taking advantage of a difference in prices in the two markets, or (2) a purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within 90 calendar days following the date of its purchase into a second security together with an offsetting sale at or about the same time of such second security for the purpose of taking advantage of a disparity in the prices of the two securities, except that when the security purchased is solely a due bill for, or other evidence of the right to receive, only the security that is sold, and the security that is sold is trading as a when-issued security, such period shall be 180 calendar days.

(e) **Special commodity account.** In a special commodity account, a creditor may effect and carry for any customer transactions in commodities.

(f) **Special miscellaneous account.** In a special miscellaneous account, a creditor may:

(1) With the approval of any regularly constituted committee of a national securities exchange having jurisdiction over the business conduct of its members, extend and maintain credit to meet the emergency needs of any creditor;

(2)(i) Extend and maintain credit, (*a*) to or for any partner of a firm which is a member of a national securities exchange to enable such partner to make a contribution of capital to such firm, or to purchase stock in an affiliated corporation of such firm, or (*b*) to or for any person who is or will become the holder of stock of a corporation which is a member of a national securities exchange to enable such person to purchase stock in such corporation, or to purchase stock in an affiliated corporation of such corporation; provided the lender as well as the borrower is a partner in such member firm or a stockholder in such member corporation, or the lender is a firm or a stockholder in such member corporation, or the lender is a firm or corporation which is a member of a national securities exchange and the borrower is a partner in such firm or a stockholder in such corporation;

(ii) Extend and maintain subordinated credit to another creditor for capital purposes: *Provided,* That

(*a*) Either the lender or the borrower is a firm or corporation which is a member of a national securities exchange, the other party to the credit is an affiliated corporation of such member firm or corporation, and, in addition to the fact that an appropriate committee of the exchange is satisfied that the credit is not in contravention of any rule of the exchange, the credit has the approval of such committee, or

(*b*) The lender as well as the borrower is a member of such exchange, the credit has the approval of an appropriate committee of the exchange, and the committee, in addition to being satisfied that the credit is not in contravention of any rule of the exchange, is satisfied that the credit is outside the ordinary course of the lender's business, and that, if the borrower's firm or corporation

or an affiliated corporation of such firm or corporation does any dealing in securities for its own account, the credit is not for the purpose of increasing the amount of such dealing.

(iii) For the purpose of subdivisions (i) and (ii) of this subparagraph, the term "affiliated corporation" means a corporation all the common stock of which is owned directly or indirectly by the member firm or general partners and employees of the firm, or by the member corporation or holders of voting stock and employees of the corporation and an appropriate committee of the exchange has approved the member firm's or member corporation's affiliation with such affiliated corporation.

(3) Purchase any security from any customer who is a member of a national securities exchange or a broker or dealer registered with the Securities and Exchange Commission under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o), or sell any security to such customer: *Provided,* That the creditor acting in good faith purchases or sells the security for delivery, against full payment of the purchase price, as promptly as practicable in accordance with the ordinary usage of the trade;

(4) Effect and finance, for any member of a national securities exchange who is registered and acts as odd-lot dealer in securities on the exchange, such member's transactions as an odd-lot dealer in such securities, or effect and finance, for any joint venture in which the creditor participates, any transactions in any securities of an issue with respect to which all participants, or all participants other than the creditor, are registered and act on a national securities exchange as odd-lot dealers;

(5) Effect transactions for and finance any joint venture or group in which the creditor participates and in which all participants are dealers (whether such participants be acting jointly or severally), or any member thereof or participant therein, for the purpose of facilitating the underwriting or distributing of all or part of an issue of securities (i) not through the medium of a national securities exchange, or (ii) the distribution of which has been approved by the appropriate committee of a national securities exchange;

(6) Effect for any customer the collection or exchange (other than by sale or purchase) of securities deposited by the customer specifically for such purposes, and (subject to any other applicable provisions of law) received from or for any customer, and pay out or deliver to or for any customer, any money or securities;

(7) Effect and carry for any customer transactions in foreign exchange; and

(8) Extend and maintain credit to or for any customer without collateral or on any collateral whatever for any purpose [4] other than purchasing or carrying or trading in securities.

(g) **Specialist's account.** In a special account designated as a specialist's account, a creditor may effect and finance, for any member of a national securities exchange who is registered and acts as a specialist in securities on the exchange, such member's transactions as a specialist in such securities, or effect and finance, for any joint venture in which the creditor participates, any transactions in any securities of an issue with respect to which all participants, or all participants other than the creditor, are registered and act on a national securities exchange as specialists. Such specialist's account shall be subject to the same conditions to which it would be subject if it were a general account except that if the specialist's exchange, in addition to the other requirements applicable to specialists, is designated by the Board of Governors of the Federal Reserve System as requiring reports suitable for supplying current information regarding specialists' use of credit pursuant to this paragraph, the requirements of § 220.6(b) regarding joint ventures shall not apply to such accounts and the maximum loan value of a registered security in such account shall be as determined by the creditor in good faith.

(h) **Special subscriptions accounts.** In a special subscriptions account a creditor may effect and finance the acquisition of a margin security for a customer through the exercise of a right to acquire such security which is evidenced by a warrant or certificate issued to stockholders and expiring within 90 days of issuance, and such special subscriptions account shall be subject to the same conditions to which it would be subject if it were a general account, except that:

(1) Each such acquisition shall be treated separately in the account, and prior to initiating the transaction the creditor shall obtain a deposit of cash in the account such that the cash deposited plus the maximum loan value of the securities so acquired equals or exceeds the subscription price, giving effect to a maximum loan value for the securities so acquired of 75 per cent of their current

[4] See § 220.7(c).

market value as determined by any reasonable method;

(2) After October 20, 1967, at the time when credit is extended pursuant to this paragraph, the creditor shall compute the amount by which the credit exceeds the maximum loan value of the collateral as prescribed by § 220.8 (the Supplement to Regulation T) and the customer shall reduce the credit by an amount equal to at least one-fourth of such sum by the end of each of the 4 succeeding 3-calendar-month periods or until the credit does not exceed the current maximum loan value of the collateral, whichever shall occur first, and, if the creditor fails to obtain the required quarterly reduction or a portion thereof with respect to a particular acquisition within 5 full business days after such reduction is due, the creditor shall promptly liquidate a portion of the collateral so acquired and apply the proceeds of the sale to reduce the credit, in an amount equal to at least twice the required payment or portion thereof for the first 2 such liquidations, at least equal to the required payment or portion thereof for the third such liquidation, and at least sufficient so that the remaining credit does not exceed the current maximum loan value of the remaining collateral after the fourth such liquidation: *Provided*, That no such liquidation need be in an amount greater than is necessary so that the remaining credit does not exceed the maximum loan value of the remaining collateral determined as of the date the credit was extended; and

(3) The creditor shall not permit any withdrawal of cash or securities from the account so long as the remaining credit exceeds the maximum loan value of the remaining collateral in the account, except that when the remaining credit extended in connection with a given acquisition of securities in the account has become equal to or less than the maximum loan value of such securities as prescribed in § 220.8 (the Supplement to Regulation T) (or in connection with an acquisition after October 20, 1967, the requirements of subparagraph (2) of this section have been fulfilled), such securities shall be transferred to the general account (or, if eligible, to a special convertible security account pursuant to § 220.4(j)) together with any remaining portion of such credit. In order to facilitate the exercise of a right in accordance with the provisions of this paragraph, a creditor may permit the right to be transferred from a general account to the special subscriptions account without regard to any other requirement of this part.

(i) **Special bond account.** In a special bond account a creditor may effect and finance transactions in exempted securities and registered non-equity securities for any customer.[5]

(j) **Special convertible debt security account.** (1) In a special convertible debt security account a creditor may extend credit on any margin security consisting of a margin debt security (i) convertible with or without consideration, presently or in the future, into margin stock or (ii) carrying a warrant or right to subscribe to or purchase such stock.

(2) A special convertible debt security account shall be subject to the same conditions to which it would be subject if it were a general account except that the maximum loan value of the securities in the account shall be as prescribed from time to time in § 220.8 (the Supplement to Regulation T).

(3) Any security which ceases to be an equity security while held in this account shall continue to be treated as an equity security as long as it is continuously held in this account.

(4) In the event any stock is to be substituted for a security held in this account, or if a security held in this account is to be used to offset a short sale in the general account, such security shall thereupon be transferred to the customer's general account against a deposit of cash or margin securities eligible for an extension of credit in this account (counted at their maximum loan value) equal to at least the maximum loan value of the security for which such substitution is made, without regard to the retention requirement of § 220.3(b)(2).

(k) **Special equity funding account.** In a special equity funding account a creditor who is the issuer or a subsidiary or affiliate of the issuer of a plan, program, or investment contract, registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77), that provides for the acquisition both of a security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8) and of insurance may arrange for the extension or maintenance of credit, not in excess of the premiums on such policy (plus any applicable interest), on a security issued by such an investment company that serves as collateral under such a plan, program, or investment contract: *Provided*, That such credit is extended or maintained by a lender subject to Part 207 of this Chapter (Regulation G) or a bank subject to Part 221 of this Chapter (Regulation U). A creditor arrang-

[5] For maximum loan value of such securities see § 220.8 (b), the Supplement to Regulation T.

ing credit in a special equity funding account shall not extend, arrange, or maintain credit in the general account or any other special account in §§ 220.3 and 220.4 of this part.

SECTION 220.5—BORROWING BY MEMBERS, BROKERS, AND DEALERS

(a) **General rule.** It is unlawful for any creditor, directly or indirectly, to borrow in the ordinary course of business as a broker or dealer on any registered security (other than an exempted security) except:

(1) from or through a member bank of the Federal Reserve System; or

(2) from any nonmember bank which shall have filed with the Board an agreement which is still in force and which is in the form prescribed by this part; or

(3) to the extent to which, under the provisions of this part, loans are permitted between members of a national securities exchange and/or brokers and/or dealers, or loans are permitted to meet emergency needs.

(b) **Agreements of nonmember banks.** An agreement filed pursuant to section 8(a) of the Act (15 U.S.C. 78h(a)) by a bank not a member of the Federal Reserve System shall be substantially in the form contained in Form F.R. T-2 if the bank has its principal place of business in a territory or insular possession of the United States, or if it has an office or agency in the United States and its principal place of business outside the United States. The agreement filed by any other nonmember bank shall be in substantially the form contained in Form F.R. T-1. Any nonmember bank which has executed any such agreement may terminate the agreement if it obtains the written consent of the Board. Blank forms of such agreements, information regarding their filing or termination, and information regarding the names of nonmember banks for which such agreements are in force, may be obtained from any Federal Reserve Bank.

(c) **Borrowing from other creditors.** A creditor may borrow from another creditor in the ordinary course of business as a broker or dealer on any registered security to the extent and subject to the terms upon which the latter may extend credit to him in accordance with the provisions of this part, and subject to any other applicable provisions of law.

SECTION 220.6—CERTAIN TECHNICAL DETAILS

(a) **Accounts of partners.** In case a general account, special bond account, or special convertible security account is the account of a partner of the creditor, the creditor, in calculating the adjusted debit balance of such account and the maximum loan value of the securities therein, shall disregard the partner's financial relations with the firm as reflected in his capital and ordinary drawing accounts.

(b) **Contribution to joint venture.** In case a general account, special bond account, or special convertible security account is the account of a joint venture in which the creditor participates, the adjusted debit balance of such account shall include, in addition to the items specified in § 220.3(d), any amount by which the creditor's contribution to the joint venture exceeds the contribution which he would have made if he had contributed merely in proportion to his right to share in the profits of the joint venture.

(c) **Guaranteed accounts.** No guarantee of a customer's account shall be given any effect for purposes of this part.

(d) **Transfer of accounts.** (1) In the event of the transfer of a general account, special bond account, or special convertible security account from one creditor to another, such account may be treated for the purposes of this part as if it had been maintained by the transferee from the date of its origin: *Provided,* That the transferee accepts in good faith a signed statement of the transferor that no cash or securities need be deposited in such account in connection with any transaction that has been effected in such account or, in case he finds that it is not practicable to obtain such a statement from the transferor, accepts in good faith such a signed statement from the customer.

(2) In the event of the transfer of a general account, special bond account, or special convertible security account, from one customer to another, or to others, as a *bona fide* incident to a transaction that is not undertaken for the purpose of avoiding the requirements of this part, each such transferee account may be treated by the creditor for the purposes of this part as if it had been maintained for the transferee from the date of its origin: *Provided,* That the creditor accepts in good faith and keeps with such transferee account