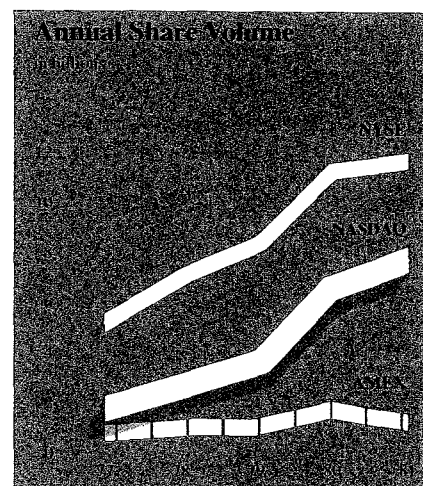
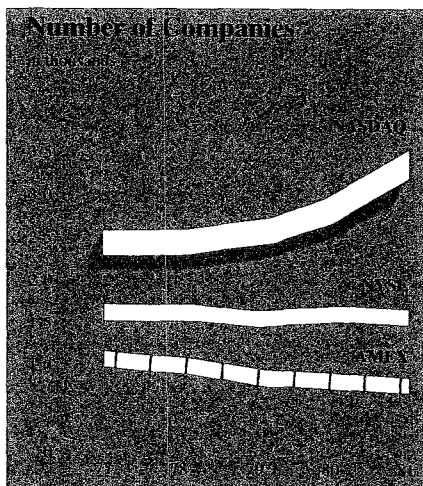


Government officials continue to consult closely with the NASD. During 1981, SEC Chairman John S.R. Shad (top) and Commissioner Barbara Thomas (bottom of page) met with the Corporate Advisory Committee. Secretary of the Treasury Donald T. Regan (center) exchanged views with the NASD Board of Governors.



in a recent survey cited multiple market makers as a major advantage over the single-specialist system of the exchanges. The average NASDAQ security has more than seven market makers who provide depth and liquidity by buying and selling for their own accounts and executing orders for customers.

The market makers frequently commit combined capital that far exceeds the resources of the exchange specialist who maintains the market for a similar listed security. Because dealers have constant access to their competitors' quotes through the NASDAQ system, quotations seldom drift far apart. If one dealer's quotes fall temporarily out of step with the market, competing dealers find it profitable to sell to him or buy from him until he adjusts his quotations. This inter-dealer trading, coupled with the visibility made possible by NASDAQ, is an important factor in maintaining a closely competitive market with narrow spreads.

NASDAQ's pioneering role in speeding and increasing the flow of information to market participants and the public has set the stage for historic changes which are about to take place in securities trading.

During the second quarter of 1982, approximately 40 NASDAQ stocks will begin trading as part of the new National Market System. For these securities, traditional bid and asked quotations will be supplemented by a constant flow of real-time trading information, including the price at which the last sale took place and continually updated volume figures.

NASDAQ will relay the day's high, low and closing trade prices for National Market System securities for publication in newspaper stock tables. About 600 additional NASDAQ securities will be eligible for the National Market System later in 1982, and very likely another 1,000 or more in 1983.

To the investing public, as well as securities industry professionals, NASDAQ is no longer the unknown quantity that quietly began to revolutionize the over-the-counter market back in 1971. NASDAQ has emerged as a world-class market, well positioned for the unprecedented changes in securities trading that are about to become a reality.

#### Eligibility Criteria for NASDAQ National List

	Alternative 1	Alternative 2
Total Assets	\$2,000,000*	\$2,000,000*
Capital and Surplus	\$1,000,000*	\$8,000,000
Public Float	350,000	800,000
Net Income	\$300,000	—
Shareholders	300*	300*
Market Value	\$2,000,000	\$8,000,000
Minimum Bid	\$3	—
Operating History	—	4 Years
Number of Market Makers	2*	2*

\*NASDAQ Requirement—Inclusion in NASDAQ is a prerequisite for inclusion on the National List.

# Operating Review

The year 1981 was an active and eventful one not only for NASDAQ, but also in a wide range of less-publicized regulatory and other areas. The common denominator of the developments noted in the following pages is NASD's continuing efforts to advance the mutually supporting interests of those it seeks to serve: investors, issuers and members.

## **NATIONAL MARKET SYSTEM: TRADING BEGINS IN 1982**

### **Long-Awaited Start-Up Will Revolutionize OTC Marketplace**

During the past year, preparation for the 1982 beginning of the National Market System (NMS) was substantially completed with the establishment by the SEC of criteria and procedures for trading NASDAQ securities through NMS and the development by NASD of the necessary automated facilities. The advent of NMS will be a historic breakthrough for NASDAQ securities—last-sale transaction information will be available to the public for the first time.

NMS will create the electronic equivalent of a ticker tape for qualified NASDAQ securities, which will be subject to real-time trade reporting. Last-sale price and volume information will be continuously displayed on the NASDAQ system. In addition to volume, daily newspaper stock tables for these securities will show the high, low and closing transaction prices—instead of the closing best bid and asked prices traditionally published for NASDAQ securities.

### **SEC Sets Criteria for NASDAQ NMS Securities**

One of the major NMS developments of 1981 occurred in February, when the SEC established two tiers of NASDAQ NMS securities. The critical requirement for

*Major items on the agenda in 1981 for the directors of NASDAQ, Inc., included the upgrading of the NASDAQ system and start-up of the National Market System.*



a NASDAQ security to be accorded Tier 1 status is an average trading volume of 600,000 shares a month for the preceding six months. Other Tier 1 criteria include at least 500,000 publicly-held shares, \$5 million market value of float, minimum bid price of \$10 per share, company net worth of \$1 million and a minimum of four market makers. NMS trading, which is mandatory for Tier 1-qualified companies, is scheduled to begin in April of 1982 for about 40 NASDAQ securities.

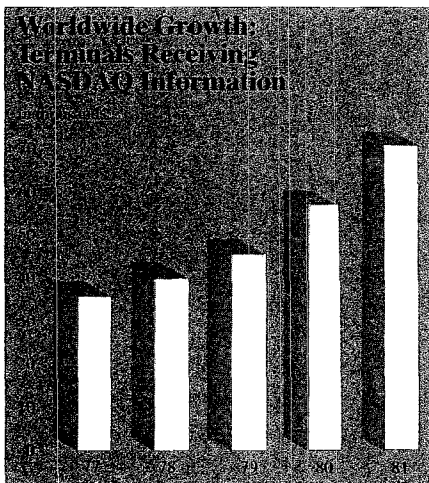
### **NASD Petitions for Changes in Proposed Tier 2 Criteria**

NASDAQ companies with securities which qualify for Tier 2, now scheduled to begin in October of 1982, will have the option of choosing whether to apply for this designation. With the inclusion of a minimum volume requirement, the Tier 2 criteria established by the SEC are more stringent than exchange listing requirements and

would limit eligibility to approximately 600 NASDAQ securities. However, NASD has petitioned the Commission to adopt more liberal Tier 2 criteria that would enable approximately 1,600 NASDAQ securities to apply for NMS designation.

These 1,600 companies are the ones that essentially meet requirements for listing on the American Stock Exchange. NASD's petition argues that the benefits of NMS designation should be equally available to companies able to meet the same requirements—whether they are exchange-listed securities traded by specialists or NASDAQ securities traded in the competitive multiple-market-maker system.

The table which appears at the bottom of page 11 shows the difference between the SEC criteria for Tier 2 (as amended in January 1982) and the two alternative sets of criteria proposed by NASD.



In late 1981, the NASD advised the SEC that unforeseen problems might result if all the securities which it recommended be made Tier 2-eligible were simultaneously introduced into the National Market System. The Association said that it was therefore developing a plan for a transition from Tier 1 to Tier 2.

In its release of January 7, 1982, the SEC adopted its amended Tier 2 criteria to become effective in October 1982. In addition, the Commission "determined to delay final action on the (NASD) proposals until there is actual trading experience under (its) Rule." This final action is expected to be taken by the end of 1982.

**NASDAQ SYSTEM:  
UPGRADE VIRTUALLY COMPLETED**

In response to unprecedented NASDAQ volume—which again shattered records in 1981—and to prepare for still greater volume in the future, the \$15 million project begun last year to upgrade the computerized core of the NASDAQ system was substantially completed.

**Powerful Central Computers Installed**

Two UNIVAC 1100/82 central computers, with three times the memory capacity and twice the speed of the previous central computers, were installed at NASDAQ's central processing complex in Trumbull, Connecticut. In addition to handling swelling NASDAQ traffic, the new computers play a major role in sophisticated surveillance of the NASDAQ market, forthcoming National Market System trading of NASDAQ issues and other automated services to the securities industry.

**1,725 Advanced NASDAQ Terminals Installed In Trading Rooms**

All of the so-called Level II and Level III NASDAQ terminals were replaced in 1981 in preparation for the increasingly automated securities market of the future. Level III terminals are used by market makers to enter and update quotations and to report volume; the Level II terminals at other locations may be interrogated but have no entry capability.

In a massive effort finally completed in December, 1,725 advanced new terminals were installed in the trading rooms of market makers, other broker/dealers and financial institutions at some 800 locations across the country, and also in the offices of regulatory and service organizations. Subscribers' orders were also placed for 71 additional new terminals at 67 sites.

The new Level II and Level III terminals are programmable and have eight times the previous display capability. They will also be able to access National Market System trading information on NASDAQ issues and interface with the Computer Assisted Execution System (CAES).

The number of Level I terminals receiving NASDAQ quotation information continued to increase sharply in 1981. These are the desk-top terminals used by registered representatives around the world to quote stock prices to their customers. There were 70,000 desk-top terminals displaying NASDAQ quotations at the end of 1981, as compared with 60,000 a year earlier and 46,000 in 1979.

**Tier 2 Criteria**

	SEC-Adopted	NASD Proposal	
		Alternative 1	Alternative 2
Publicly Held Shares	250,000	400,000	1,000,000
Market Value of Float	\$3 million	\$3 million	\$10 million
Bid Price	\$5 on each of 5 business days	\$5 on each of 5 business days	None
Net Worth	\$1 million	None	None
Tangible Assets	\$2 million	\$4 million	\$12 million
Net Income	None	\$400,000 in last fiscal year or in 2 of last 3 years	None
Trading Volume	Average 100,000 shares per month for 6 months	\$1 million in last 12 months	\$1 million in last 12 months
Market Makers	4 on each of 5 business days	4 on each of 5 business days	4 on each of 5 business days
Operating History	None	None	5 years

### Start-Up Problems Addressed

Unexpected difficulties were encountered during the installation period of the new terminals. NASDAQ, together with the suppliers of the new equipment, worked hard to solve initial problems by establishing a NASDAQ/Vendor Task Force to analyze and correct deficiencies in the terminals, increase availability of maintenance services and equipment needed to diagnose problems, and install more basic telephone circuits and alternative back-up lines. Despite these start-up difficulties, the capacity of the NASDAQ system was reflected in the volume of traffic it handled in 1981. Traffic averaged 940,241 calls daily, and peak traffic for a single day was 1,195,291 calls.

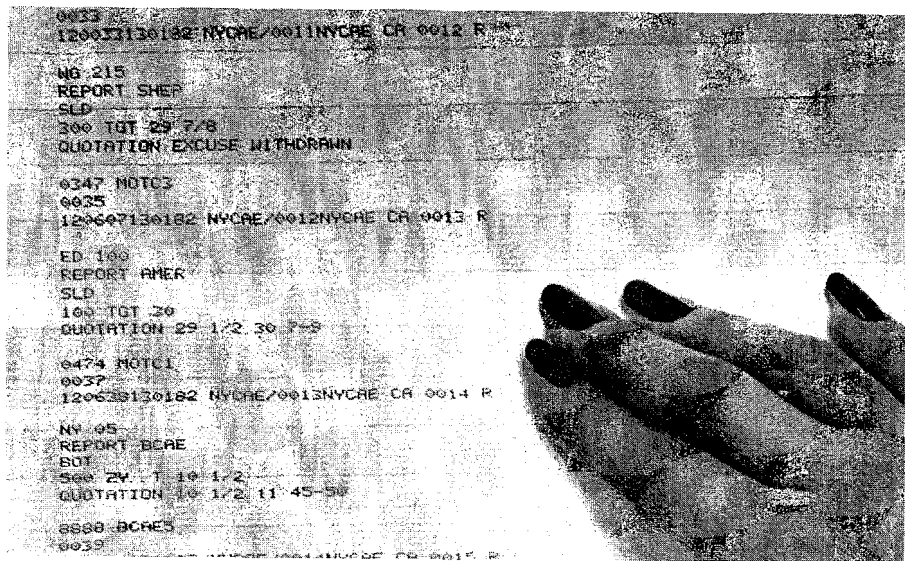
### Additional Capabilities Built In

When the upgraded NASDAQ system is fully operational, it will represent the state of the art in modern automation technology. The system is equipped with network controls to help provide early warnings of possible malfunctions and rapid diagnosis of problems. There is also a dial back-up capability which makes it possible to switch a NASDAQ terminal from a faulty telephone line to a functioning one.

### CAES Operating in Pilot Phase

The Computer Assisted Execution System (CAES) is an automated order-routing and order-execution system. Developed to help effect transactions at the best available price and in the most efficient manner, CAES has been operated on a pilot basis by an NASD subsidiary, NASD Market Services, Inc., since February 20, 1981, in anticipation of the advent of the National Market System. Eighteen order-entry firms and off-board market makers have been

*The Computer Assisted Execution System (CAES), operated on a pilot basis during 1981 by NASD Market Services, Inc., automatically executes a transaction and creates a record on paper for both the buyer and the seller.*



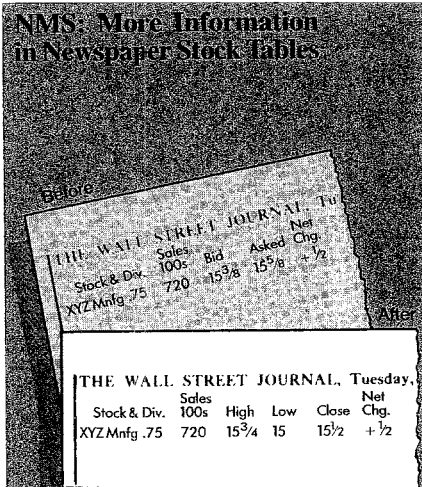
participating in experimental CAES trading in exchange-listed stocks, including a number of so-called 19c-3 stocks (those listed after April 26, 1979, and exempt from exchange restrictions on off-board market making by virtue of SEC Rule 19c-3).

### CAES Linkage Planned With Intermarket Trading System

When it is linked by SEC mandate with the Intermarket Trading System (ITS) during 1982, CAES will diminish the competitive disadvantage of off-board market makers in 19c-3 stocks. During the 19c-3 experiment, exchange member firms have found it more economical to utilize their own automated facilities for routing orders to stock exchanges rather than to off-board market makers without comparable facilities. As a result, off-board market making in 19c-3 securities was severely reduced.

Seventy-five percent of the securities lost all of their previous NASDAQ market makers after exchange listing, 12 percent were left with only one off-board market maker and only 13 percent retained more than one market maker.

When CAES links with ITS, it will enable off-board market makers to direct 19c-3 orders for execution by specialists on the floors of the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia Stock Exchanges without floor brokerage charges. It will also enable specialists and floor brokers on these exchanges to enter 19c-3 orders into ITS for automatic execution by the CAES market makers displaying the best bids and offers in the Consolidated Quotation System.



**CAES Will Also Automate National Market System Trading**

In addition to its ITS linkage for 19c-3 trading, CAES will become available for trading in the National Market System during 1982. CAES will provide automatic execution of a transaction and create a record on paper for both the buyer and the seller. The CAES capability will be available on all new NASDAQ terminals.

**SERVICES TO NASDAQ ISSUERS: SCOPE CONTINUES TO INCREASE**

**Presidents' Conferences Draw Record Attendance**

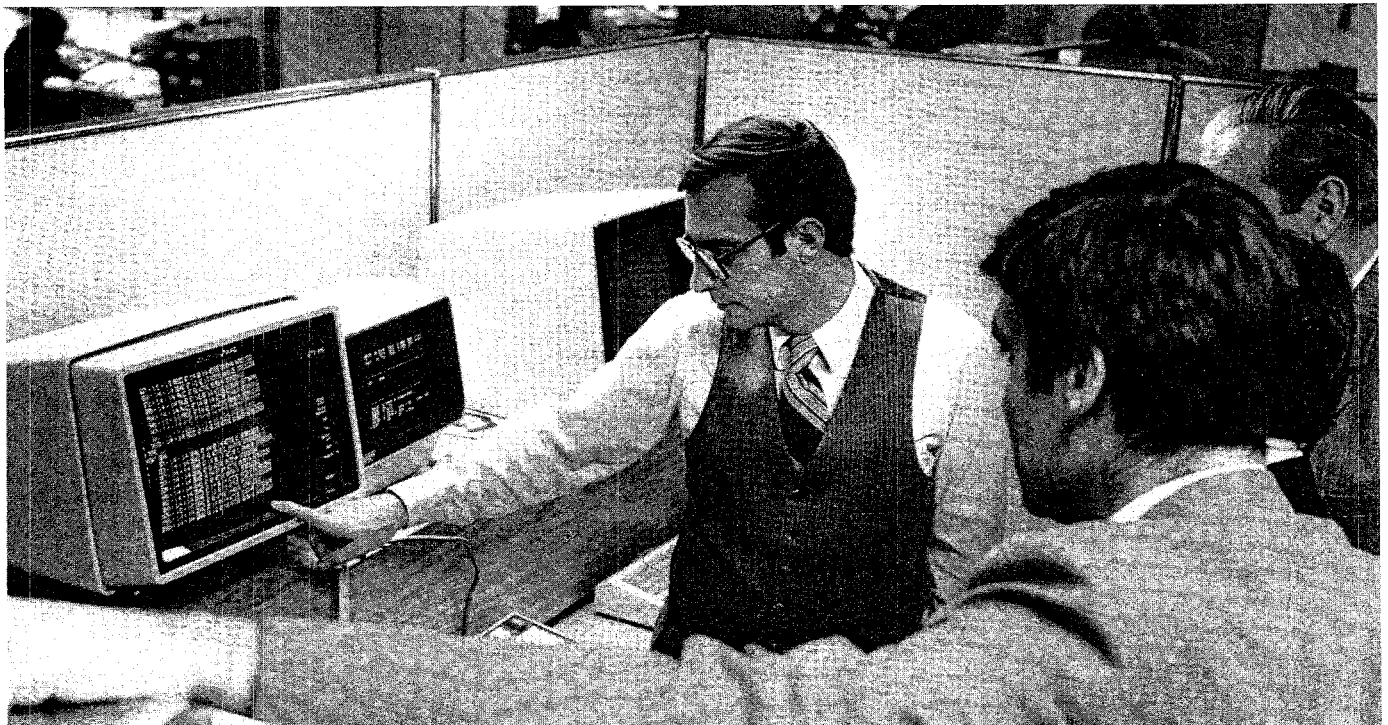
The 1981 NASDAQ Presidents' Conferences, held in 15 cities in October, drew the largest attendance in the eight-year history of nationwide NASD consultations with issuer companies. A total of 773 senior executives of 526 companies

attended the half-day sessions. NASD officials and leading outside experts spoke on six key subjects for top management:

- Financing strategies in an era of volatile capital markets;
- Mergers and acquisitions: offense and defense;
- Ways to improve shareholder communications;
- Senior management's role in investor relations;
- Update on the implications of the National Market System;
- NASD's new program to increase NASDAQ's recognition and visibility.

The goals of the Presidents' Conferences are to facilitate two-way communication between NASD and NASDAQ companies and to brief company leaders on emerging issues and trends in the financial markets which will significantly affect how investors value their securities. The Conferences are one element of an expanded public information program begun in 1981 to increase awareness and understanding of the NASDAQ market among issuer companies, institutional investors, the securities industry and the financial press.

*The computerized Market Information Data Access System (MIDAS), seen here in a demonstration, is a powerful surveillance tool which provides on-line access to up to 60 days of price data about every NASDAQ security.*





*The Corporate Consultants program provided individual assistance to nearly 300 NASDAQ companies during 1981. Lewis M. Weston (right), who consults with companies based in the Northeast, meets with Salvatore T. DiMascio, vice president-finance of Conair, Inc., at the firm's New Jersey headquarters.*



### **Corporate Consultants Offer Companies Individual Assistance**

The NASDAQ Corporate Consultants program continued to offer individual assistance to NASDAQ companies in 1981. A fourth consultant, W. Eugene Cartwright, was appointed to serve NASDAQ companies in the Far West. He joined the three consultants appointed in 1980: Douglas H. Curtis for the Midwest, Raymond J. Kiernan for the Southeast and Lewis M. Weston for the Northeast.

Extensive management and securities industry expertise enables the NASD consultants to provide professional counsel on matters such as working with market makers, security analysts, investment bankers and broker/dealers; shareholder and media relations; and techniques for increasing the visibility of a company's

securities. During the year, nearly 300 NASDAQ companies took advantage of this service. A fifth corporate consultant will join the team in 1982 to provide full nationwide coverage.

### **New Studies Show Exchange Listing Does Not Reduce Risk or Cost of Capital**

In order to develop definitive information on an important subject, NASD commissioned an impartial outside study to examine critically the effect of exchange listing on risk and the cost of capital for NASDAQ companies. The study was conducted by Richard Zecher, former Dean of the College of Business Administration of the University of Iowa and now Chief Economist of the Chase Manhattan Bank, and Susan Phillips, former Associate Professor of Finance at Iowa and now a Commissioner of the Commodity Futures Trading Commission.

The Zecher/Phillips study explored both the differences in risk between matched pairs of exchange-listed and OTC securities and the effect of exchange listing on the price level and price volatility of a large sample of issues. It concluded that "... listing status does not affect risk or the cost of capital for companies of similar asset size, industry group and trading volume. Further, the decision to list does not appear to have any predictable effect on risk or the cost of capital for the listing company."

The findings of Zecher and Phillips are heavily supported by another recently completed study which was independently prepared by H. Kent Baker, Professor of Finance at American University, in conjunction with James Spitzfaden, Internal Auditor for Textron. Although the Baker/Spitzfaden study involves approaches which differ somewhat from those of Zecher and Phillips, its conclusion is that "... listing on the AMEX or NYSE is not a thing of value with respect to lowering a firm's cost of equity capital."

### **MARKET SURVEILLANCE: STATE-OF-THE-ART EQUIPMENT ENHANCES CAPABILITIES**

#### **MIDAS Goes On-Line**

In July, the computerized Market Information Data Access System (MIDAS) became operational, the culmination of more than a year of effort. MIDAS is a major enhancement of NASD's already strong market surveillance capabilities. The new system provides the 17 NASD professionals assigned exclusively to Market Surveillance with instantaneous, on-line access to up to 60 days of price information about every NASDAQ security. Analysts can recapture quotations data on a second-by-second basis and reconstruct trading patterns as

they occurred. This gives the Association the ability to create a complete audit trail of quotation activity for all market makers.

**Statistics Show Surveillance Effectiveness Increasing**

MIDAS supplements NASDAQ's existing computer programs, which test price, volume and other parameters for every NASDAQ security. When unusual activity occurs, a parameter break is set off, and Market Surveillance analysts immediately investigate to determine whether the behavior of the stock was due to legitimate market forces or manipulative or other improper trading practices.

In 1981, there were 5,045 on-line price parameter breaks, up 21 percent from 1980 and more than three times the level of two years ago. These on-line notifications, as well as other surveillance monitoring capabilities, led to 830 formal reviews of unusual price or volume activity. Additionally, a total of 135 investigations were conducted in 1981, nearly twice the number conducted in 1980. Referrals to the SEC, NASD District Offices or the NASD Anti-Fraud Section totaled 46 in 1981.

Another indication of NASD's heightened surveillance activity is the increase in quotation halts from 523 in 1980 to 627 in 1981, or 18 percent in a year. These are situations where quotations in a security are withheld from NASDAQ screens by NASD, pending dissemination of material news about a company that could affect the price of its stock. The purpose is to ensure that all investors have equal access to relevant information, thereby protecting the integrity of the OTC market. The vast majority of quotation halts were undertaken with the full cooperation of NASDAQ issuer companies. Once news has been adequately disseminated, quotations are resumed.

**Insider-Trading Abuses Detected**

NASD Market Surveillance has been especially active in scrutinizing speculative activity and in ferreting out illegal insider trading. For example, the SEC has brought charges in 32 insider-trading cases of various kinds since 1978. Seven of the eight prosecutions involving insider trading in NASDAQ issues grew out of investigations initiated by NASD Market Surveillance and referred to the Commission.

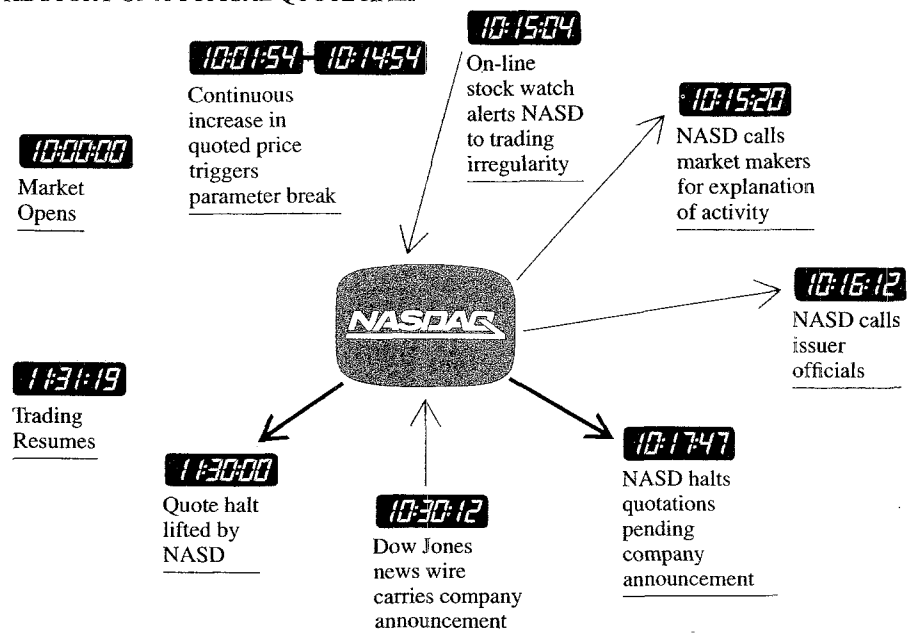
In one well-publicized situation in 1981, a director was negotiating to sell a large block of company shares at a price approximately 40 percent over the then-current market quotation. A volume surge in the week preceding the public announcement, together with the quotation halt at the time of the announcement, alerted NASD Market Surveillance to the possibility of insider trading based on a news leak. Subsequent investigation revealed that, although the

*NASD's Market Surveillance Section monitors the major business news wires throughout the trading day for company announcements that might affect price quotations of NASDAQ issues.*



**Computerized Surveillance Systems Help NASD Police NASDAQ Market**

**THE STORY OF A TYPICAL QUOTE HALT**



*Through the NASDAQ system, each broker/dealer has immediate access to the quotations of all other broker/dealers who are making markets. Inter-dealer trading, coupled with the nationwide visibility made possible by NASDAQ, is an important factor in maintaining a highly competitive market with narrow spreads.*



company itself was not involved, illegal insider trading by associates of the director had indeed been responsible for the unusual volume increase.

In another 1981 case, a NASDAQ company requested a quotation halt on June 30 to announce it had received a tender offer from an unidentified European company for \$22 a share. The shares were selling at  $13\frac{1}{8}$  before the announcement and  $16\frac{1}{4}$  immediately afterward. However, on June 25, the stock had jumped from  $10\frac{1}{2}$  to 12 on volume nearly eight times that of the previous day. This set off several parameter breaks and prompted an investigation by NASD Market Surveillance. On July 6, the company announced

that the tender offer had been withdrawn, and the stock price subsequently sank. The NASD probe revealed that the tender offer was fictitious. Without the knowledge of the company, its general counsel had fabricated the offer and distributed the press release to boost the price of a block of shares he had purchased previously.

#### **NASD 19c-3 Surveillance is Commended by SEC**

Since the adoption of SEC Rule 19c-3 in 1980, which permits off-board trading by exchange members in certain listed securities, NASD has had a special surveillance program in place to monitor this activity. In August 1981, an SEC report on the off-board trading experiment complimented NASD's "serious, meaningful effort" in 19c-3 surveillance and cited

the Association's program as one justification for its assessment that no additional regulatory steps are necessary in this area.

#### **Foreign Securities Review Begins**

A special Ad Hoc Committee on Foreign Securities has been formed to evaluate existing qualification requirements for foreign securities traded through NASDAQ and to determine if there is a need for admission criteria consistent with that required for domestic companies. The Committee is made up of NASD members and bank representatives active in foreign issues. It is currently comparing listing requirements for foreign exchanges with those of NASDAQ and expects to make recommendations in 1982.

#### **Intermarket Surveillance Group Formed**

Also in 1981, NASD joined representatives of other self-regulatory organizations in forming an Intermarket Surveillance Group to coordinate efforts to monitor trading in listed equities and options that occurs in multiple marketplaces. The group worked to determine the kinds of data necessary for effective surveillance of trading in multiple markets, techniques for identifying typical violations, appropriate communication channels among the self-regulators involved in intermarket investigations and coordination procedures with the SEC. A report on the group's progress and prospects was presented in December to SEC Chairman John S.R. Shad. Among the priorities for 1982 is to develop automated methods of exchanging surveillance data.



**BROKER/DEALER REGULATION:  
NEW PROGRAMS AUGMENT  
ONGOING MONITORING**

**“Early Warning” Efforts Stepped Up**

In recognition of the volatile economic climate, NASD stepped up its already established “early warning” system to detect financial and operational problems that might undermine the strength of member firms. This additional surveillance encompasses both the equity and municipal bond markets and includes independent verification of municipal bond inventory valuations, on-site financial and operational reviews and examinations, increased reporting, and special surveys.

**Regional Attorney Program Begins**

The Association started a Regional Attorney program in 1981 to provide specialized legal guidance and expertise to

District staffs and Committees in investigations and disciplinary proceedings. Regional Attorneys review the sufficiency of evidence before complaints are issued and, working with the District Director, draft complaints and conduct disciplinary proceedings in the Districts within the region. The purpose is to strengthen NASD’s disciplinary process by providing District Committees with better information and legal advice upon which to make the required “businessman’s judgment.”

**Disciplinary Actions Increase**

In discharging its regulatory responsibilities, NASD conducted a total of 3,154 routine and special examinations of member broker/dealers in 1981. This figure included 2,655 main-office examinations and 499 branch-office examinations. As a result, NASD issued 213 formal and

summary complaints and also accepted 45 Letters of Admission, Waiver and Consent during the year. These actions led NASD to expel seven firms, bar 64 individuals, and suspend four firms and 55 individuals.

**Routine Examinations Streamlined**

During 1981, NASD also moved to increase the cost-effectiveness of its regulatory efforts by focusing resources on higher priority examinations. This was accomplished by reducing the number of routine

*On-site examinations by NASD auditors (seated and on the left) are designed to provide early detection of problems that might undermine the strength of member firms.*



examinations conducted at member firms with exemplary records. Districts were given the discretion to defer for a year annual routine examinations of broker/dealers meeting stringent financial and operational criteria, as well as criteria related to customer complaints and disciplinary history. As a result of this program, overall regulatory efficiency was increased.

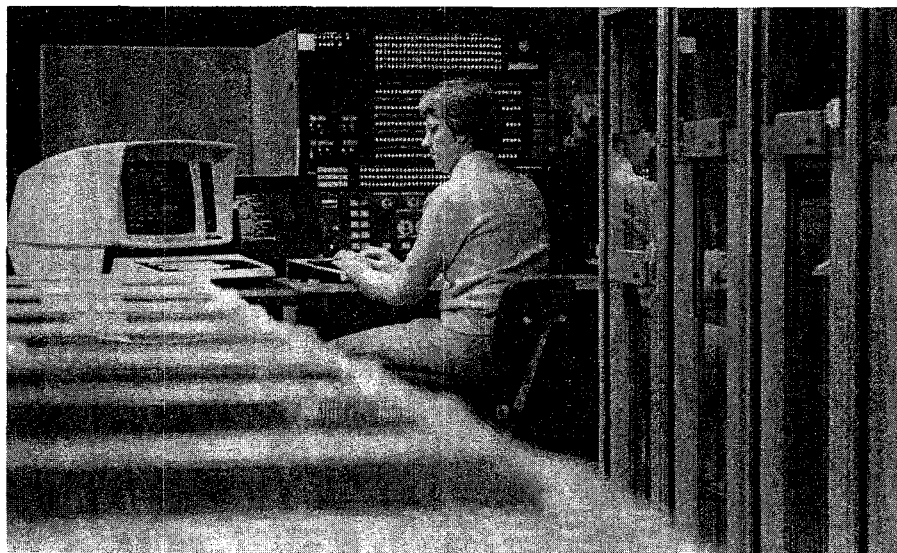
#### **Regulatory Duplication Eliminated in Options Trading**

The Association entered into what is known as a Multi-Party Options 17d-2 Agreement to end redundant "upstairs" examinations of dual members involved in options activities. The other self-regulatory organizations (SROs) involved in the agreement are the Chicago Board Options Exchange and the American, Midwest, Pacific and Philadelphia Stock Exchanges. Regulatory responsibility rotates among the SROs, and only one group is the "designated options examining authority" at any given time. This SRO is responsible for conducting options examinations, including the investigation of all relevant complaints from customers and terminations for cause of registered personnel.

#### **Philadelphia Agreement Further Reduces Duplication**

In October, the Association entered into an agreement with the Philadelphia Stock Exchange (PHLX) to establish NASD as the designated examining authority for broker/dealer members of both NASD and PHLX who were previously assigned to the PHLX. Similar agreements with the Boston, Cincinnati, Midwest and Pacific Stock Exchanges remain in effect, eliminating regulatory duplication for the members involved.

*The Computer Center at NASD headquarters in Washington is the hub of internal automation and is linked directly to the central computers of the NASDAQ System in Trumbull, Connecticut.*



#### **Self-Liquidations Function Smoothly**

NASD supervised the self-liquidation of three member firms during 1981. Since the Association began this program in 1975, the self-liquidation of 73 firms has distributed approximately \$57 million in cash and securities to satisfy outstanding obligations to customers and broker/dealers.

#### **Cooperation Continues with SIPC**

During the year, 10 broker/dealers were placed in liquidation under the auspices of the Securities Investor Protection Corporation (SIPC). Seven of these were designated to NASD. At the end of 1981, the Association was the designated examining authority for 2,860 members, five of which were on report to SIPC as in or approaching financial difficulty.

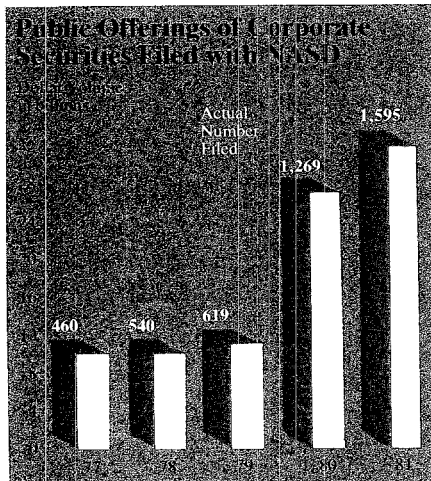
#### **Free-Riding Questionnaires Increase**

With strong investor interest, particularly during the first part of the year, the number

of new issues brought to market in 1981 reached 2,073, up 27 percent from the 1,628 of 1980. Many of these new issues advanced to an immediate premium in the after-market. As a result, free-riding questionnaires for 134 issues were authorized and forwarded to members in 1981. This represents a 74 percent increase over the 77 issues for which questionnaires were processed during 1980 and a nearly seven-fold rise from the 20 of a year earlier.

#### **More Customer Complaints Resolved**

NASD is pleased to report that the number and percentage of customer complaints it resolved rose once again in 1981. During the year, 1,423 complaints were received and 1,340, or 94 percent, were resolved. Last year, 984 customer complaints (92 percent) were resolved of the 1,071 complaints received.



### More Advertising Reviews Conducted

The Association's advertising department reviewed over 11,000 pieces of advertising and sales literature filed by members during 1981, compared with 9,700 pieces reviewed in 1980. Approximately 45 percent of these member filings were voluntary. In addition, approximately 4,150 pieces of material were received from members in response to routine spot-checks, compared with 3,700 in 1980. Overall volume has increased in each of the last five years and was 79 percent higher in 1981 than in 1977.

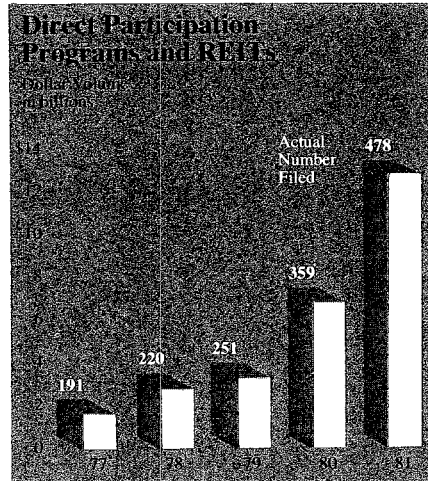
### Mutual Funds Guidelines Adopted

In December, the Association adopted guidelines regarding members' advertising and sales literature about mutual funds and variable contracts. These guidelines, which had been published for comment in the spring, are intended to assist members in complying with applicable NASD rules.

### Public Offerings Increase

Public offerings filed with the Association for review of underwriting terms and arrangements were up again in 1981, although the increase was less dramatic than in 1980. The 2,073 offerings that were filed had an aggregate registered amount of just over \$44 billion. The number of offerings increased 27 percent over 1980, while the dollar amount was up 29 percent.

The number and dollar amount of direct participation programs and real estate investment trust (REIT) filings again showed a significant annual increase, up 33 percent in number and 86 percent in dollar amount. This category of filings accounted for 478 offerings, with a registered amount of more than \$12.5 billion in 1981.



### More Insurance Company Representatives Are Registered

Approximately 80,000 of the representatives registered with the NASD are primarily engaged in the insurance business as agents of major insurance companies. Historically, few insurance agents have devoted much of their activity to the sale of the variable annuities and/or mutual funds distributed by their companies. This situation is changing rapidly as insurance companies gear up to provide a broader range of financial services to their customers, and, as a result, an increasing number of insurance agents are becoming registered as representatives with the Association.

Many insurance agents with sophisticated clients are also broadening the scope of their activities. They are registering as investment advisers, developing financial planning services and qualifying to sell securities (such as direct participation programs) not traditionally offered by insurance representatives. Real estate and oil and gas programs are currently the most popular offerings.

Concurrent with these developments, many life insurance companies are introducing new products which separate the insurance and investment elements of the traditional life insurance policy. Advocates of these new contracts claim they are more advantageous to consumers in the current economic climate of high interest rates and inflation.

### Courts Uphold NASD Disciplinary and Arbitration Processes

Two actions challenging the NASD disciplinary and arbitration processes were filed during the year in the Federal courts. The NASD was upheld in both cases by the district courts, with one decision subsequently affirmed at the appellate level and the other pending in a Federal appeals court at year-end.

In the first case, an action seeking a preliminary injunction against both the NASD and the SEC was filed in the U.S. District Court for the Western District of Michigan by an NASD member firm and its President and majority stockholder. The plaintiffs contended that the NASD had unconstitutionally expelled the firm from membership and that the SEC was seeking



*The 1981 NASDAQ Presidents' Conference, held in 15 cities in October, drew the largest attendance in the eight-year history of nationwide NASD consultations with issuer companies.*

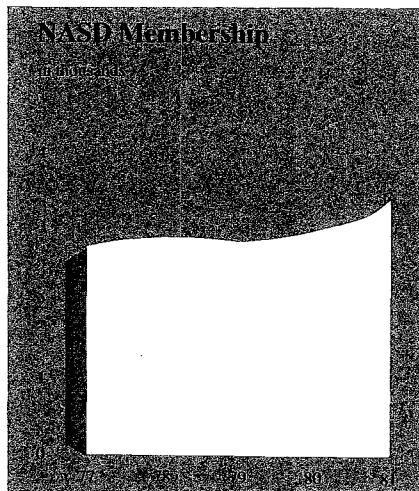
to preclude the firm from functioning as an SEC-only broker/dealer. The Court dismissed the plaintiffs' complaint, holding that they had failed to exhaust their administrative remedies. The plaintiffs appealed the decision to the U.S. Circuit Court of Appeals for the 6th Circuit and also asked the District Court for relief from its order of dismissal. The District Court denied the application for relief, and the dismissal of the original complaint was subsequently affirmed by the Appeals Court.

The second action was commenced in the U.S. District Court for the District of Oregon by an individual who was formerly a registered representative with an NASD member firm. The plaintiff sought a judgment declaring that because he had terminated his registration with the NASD, he was not subject to the jurisdiction of an NASD arbitration panel in an action relating to his activities during the period he was registered. The District Court granted NASD's motion for summary judgment and ordered the individual to proceed with NASD arbitration, thereby rejecting his assertions that NASD registration does not constitute a binding agreement to arbitrate or, alternatively, that termination of registration voids any such agreement. The matter has been appealed to the U.S. Court of Appeals for the Ninth Circuit, where it is awaiting a decision following submission of briefs and oral argument late in the year.

#### **MEMBER SERVICES: STEADY EXPANSION CONTINUES**

##### **Membership On the Rise**

For the second year in a row, the number of firms admitted to membership in the NASD rose significantly. Total membership is now 3,265, 11 percent more than last



year. In addition, 294 additional applications were pending at year-end. A large number of the new firms are involved in the distribution of limited partnerships and other direct participation programs.

##### **Registered Representatives Increase**

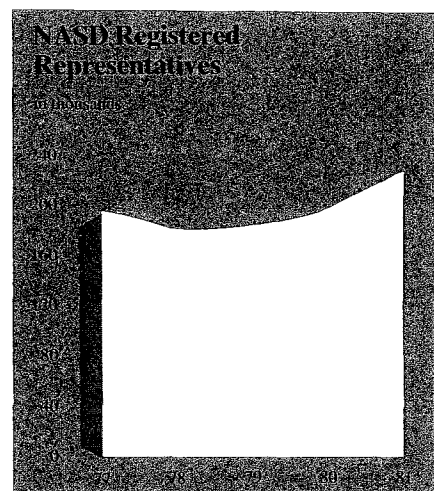
The number of newly qualified registered representatives also showed a continuation of the strong growth trend that started last year in response to increasing activity by individual investors. There are now some 220,000 registered representatives, up 12 percent from 1980 and 20 percent from the year before.

##### **Computerized CRD System Begins**

In collaboration with the North American Securities Administration Association, NASD inaugurated the Central Registration Depository (CRD), a computerized system designed to streamline the application and licensing procedure for registered representatives in various states. Twenty states are already participating, and 12 states are expected to join CRD in 1982.

The basic idea behind CRD is to enable a broker/dealer to submit a single form and a single check for a prospective representative that automatically generates multiple registrations and licenses—thus eliminating the cost and paperwork of separate, identical filings with numerous states and self-regulatory organizations. CRD provides for annual state licensing renewals and, in the future, will also provide for on-line data entry and retrieval by member firms, an automated registration-billing system, and the maintenance of broker/dealer registration data.

CRD began in June and was immediately followed by a steady increase in the number



of applications, which by October had reached a level three times the pace of previous years. This unexpected volume, coupled with start-up difficulties to be expected in any new system of this complexity, severely strained the processing capabilities of the CRD during its first few months of operation. The delays that resulted are being resolved, and NASD is spending an additional \$1.5 million on CRD equipment and programming enhancements.

##### **Automated Examinations Help Handle Increased Volume**

As test administrator for the securities industry, NASD administered over 100,000 qualification examinations during 1981 for itself, other SROs, the states, the SEC and commodity exchanges. This is 67 percent above last year's volume and double the figure of just two years ago. In order to handle increases of this magnitude, NASD has increasingly sought to automate testing and streamline overlapping examinations.

In 1981, some 60 percent of the NASD's examinations were administered on Control Data Corporation's PLATO System through its nationwide network of computerized learning centers. This automation has helped expedite the testing process and make it more convenient for the securities industry.

In conjunction with the Municipal Securities Rulemaking Board, the New York Stock Exchange and the options exchanges, NASD developed a new principal examination for General Securities Sales Supervisors. This new test



replaces four separate ones previously required of supervisory sales personnel, thereby providing a more efficient and uniform qualification standard.

**New TARS System Designed to Improve Clearing**

An innovation that will improve the market for NASDAQ issues, especially during periods of high market activity, is the Trade Acceptance and Reconciliation Service (TARS). TARS will provide an on-line data base of all trade information normally received through the clearing corporations the morning after trades occur. From this data base, members may request on their NASDAQ terminals the immediate display of information on compared and "trouble" trades and may also utilize their NASDAQ terminals to enter immediate corrections.

Phase 1 of TARS, which is scheduled for implementation in 1982, will provide service to current clearing members. Phase 2, scheduled for implementation in 1983, will extend the service to all members and all securities.

**Secondary Market for Limited Partnerships Developed**

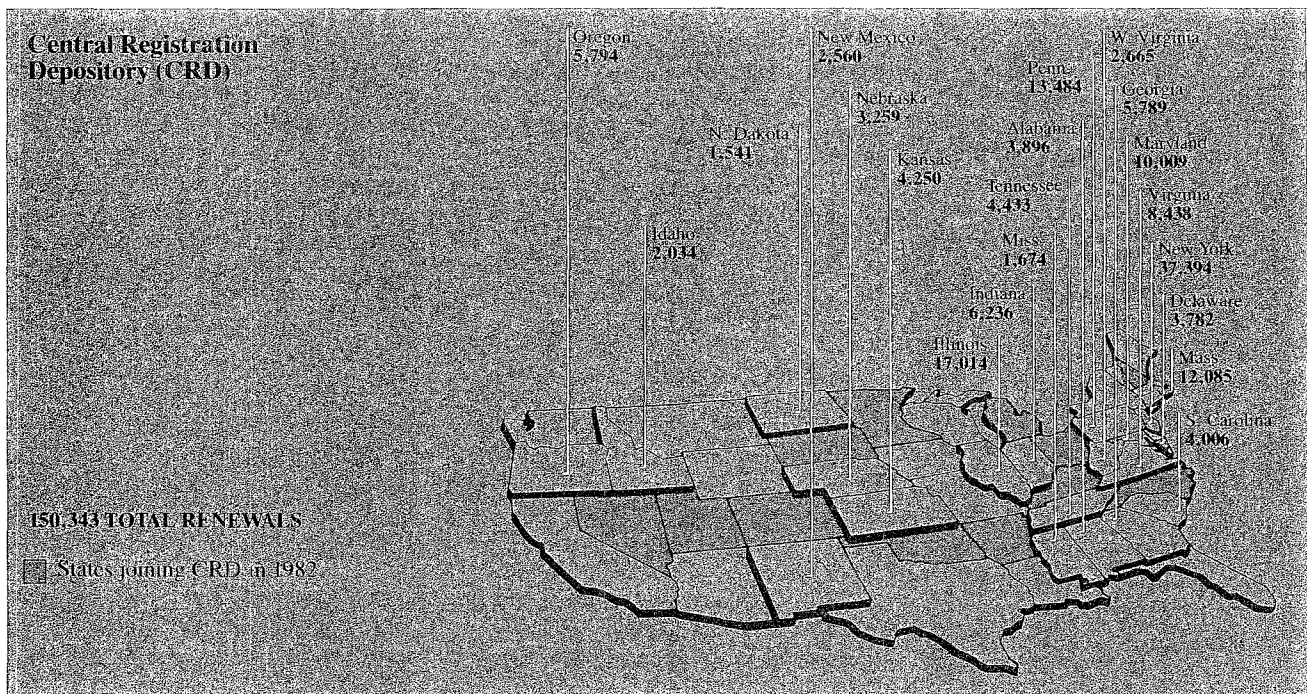
Several years of work came to fruition in 1981 with the development of a plan for a computerized communication system that will enable members to exchange information on limited-partnership interests available for secondary trading. Based on the preferences expressed in a membership study, the new system will utilize some aspects of NASDAQ. It will not require "firm" quotations, but instead will allow members to transmit indications of interest in the purchase or sale of public limited partnerships.

**Group Buying of Fidelity Bonds Studied to Reduce Costs for Members**

NASD has been exploring for some time the possibility of sponsoring a group-buying program for fidelity bonds in order to generate cost savings for members. The insurance brokerage firm of Marsh & McLennan Inc. was appointed to design and implement such a program, which is expected to be available in 1982.

**New Publications Assist Members**

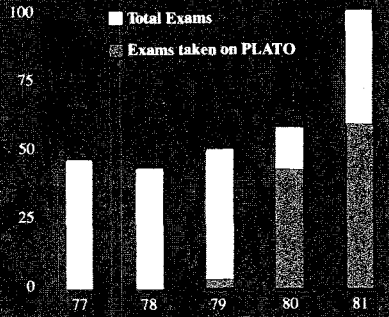
During 1981, NASD produced a variety of new publications to help broker/dealers avoid compliance problems and operate at maximum efficiency. One of them was a compendium of information on due diligence requirements. Based on NASD seminars, the book is a compilation of presentations made by leading securities attorneys and underwriters. Nearly 10,000





### Qualification Tests Administered by NASD

in thousands



*Control Data Corporation's PLATO System expedites qualification examinations for registered representatives by electronically recording answers and immediately providing a final score upon completion.*

copies have been distributed, and the Association is continuing to make them available to members on request.

NASD also published "The Compliance Check List," a brochure to assist members in establishing effective compliance programs for both main and branch offices. Used in conjunction with a firm's internally developed audit guides and supervisory procedures, the brochure will help members avoid unintentional violations of applicable rules and regulations.

"The Q & R Report" is a newsletter developed in 1981 to help member firms in qualifying and registering prospective representatives. The need for this publication arose from the advent of the CRD system and other significant changes in the registration process. It contains up-to-date information and answers to frequently asked questions.

NASD also published a "Guide to Information and Services," a detailed listing of the names and direct telephone numbers of several hundred NASD people who work most closely with specific rules, regulations and services. This booklet, which will be updated yearly, will help members and others get answers to their questions as quickly as possible.

At the end of the year, the "NASDAQ Subscriber Bulletin" made its appearance. This will be a frequent report to keep system subscribers informed of steps taken to improve reliability and on enhancements in place or projected for the future.

### PROPOSED RULINGS: NASD COMMENTS REFLECT NEEDS OF OTC MARKET

#### Extensive Comments Made on Proposed Changes in Net Capital Rule

In a 16-page letter, NASD submitted in March extensive comments to the SEC in response to proposed changes in the Net Capital Rule. The Association supported the Commission's overall objective of upgrading the adequacy, liquidity and permanence of the industry's capital. It agreed that the thrust of the proposed revisions are constructive but suggested changes in many areas, including minimum net capital requirements, "haircuts," treatment of fails, limitations on the withdrawal of equity capital and early warning levels.

The Association also provided detailed comments on future financial responsibility rules for broker/dealers. It recommended retaining the "Customer Protection Rule" (Rule 15c3-3), coupled with a modified liquidity concept derived from the current alternative method of computing net capital. NASD believes that its recommendation may serve as the basis for a future SEC-industry dialogue on how to structure broker/dealer financial responsibility criteria for the '80s and beyond.

#### Simplification of Margin Requirements Supported

During 1981, the Federal Reserve Board (FRB) continued its comprehensive review of Federal credit regulations. NASD strongly supported the objective of several proposed FRB amendments to Regulation T, which governs extension of credit by brokers and dealers. Many of the proposed amendments simplify Regulation T and reduce the burden of complying with it.

Other FRB amendments proposed systems of credit regulation to cover the trading of options on exempted debt issues. In supporting the proposed changes, NASD also made a number of suggestions to simplify and modernize Regulation T even further and to make it easier to understand for both borrowers and lenders.

#### SEC Proposal on Customer Complaint Registries Opposed

Earlier in the year, the Association commented on a controversial Commission proposal to establish customer complaint registries. As proposed, Rule 17a-24 would have required all registered broker/dealers, SROs and the Municipal Securities Rulemaking Board to submit all securities-related customer complaints to a self-regulatory organization designated by the Commission to maintain a central complaint file. Reports on the resolution of all complaints previously forwarded to the central file would also have been required. In its comments on the proposal, the NASD cited its concern over the measure's potential for duplicative regulation, its high cost/benefit ratio and the paperwork burdens it would create for the industry. The Association is hopeful that its views and those of other commentators have persuaded the Commission to reconsider this proposed measure.

#### No New Rules Needed for Business Development Companies

The Small Business Investment Incentive Act of 1980 authorized a new entity, called a "business development company" (BDC), to provide investment capital and managerial assistance to small firms. At the request





of Congress, the Association reviewed the applicability and adequacy of existing NASD suitability requirements to the purchase and sale of interests in BDCs. After study, NASD's Joint Industry/Government Committee on Small Business Financing concluded that the existing suitability rules are applicable to the sale of investments in BDCs and that there is no need for specialized suitability rules from customer-protection and public-interest perspectives.

#### **Rule Change for Regulation of Limited Partnerships**

Based on a review by the Corporate Financing Department, the Association has proposed a rule change to the SEC regarding NASD regulation of direct participation programs, primarily limited partnerships. The proposed rule, to be contained in Appendix F of the Rules of Fair Practice, is limited to questions affecting broker/dealers, such as suitability, due diligence, and

organization and offering expenses. There is to be no additional regulation of most sponsor activities, since an NASD study showed that this was not necessary.

#### **Elimination of 10-Day Withdrawal Period Advocated**

NASD also recommended to the Commission that the 10-day withdrawal provision of Rule 10b-6 be eliminated. Among other things, 10b-6 requires NASDAQ broker/dealers to stop making markets 10 days prior to a new offering. The NASD proposal would substantially reduce the impact of the withdrawal provision and clarify many other aspects of the Rule.

*The Central Registration Depository (CRD) Communications Section at NASD headquarters provides on-line information about registrations to member firms.*