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FINAL SEGMENT OF SEC MARKET STUDY REPORT FILED

The Securities and Exchange Commission today filed with Congress the third and final segment of the Report of the Special Study of Securities Markets on the adequacy of investor protection in the securities markets. The four chapters submitted today, which are summarized in Special Market Release Nos. 35-38,[1] are as follows:

Chapter X	-	Security Credit
Chapter XI	-	Open-End Investment Companies (Mutual Funds)
Chapter XII	-	The Regulatory Pattern
Chapter XIII	-	The Market Break of May 1962

In transmitting the four chapters of the Report to Congress, Chairman William L. Cary stated in behalf of the Commission:

Sir:

I have the honor to transmit the final installment of the Report of the Special Study of Securities Markets containing Chapters X through XIII. This Report is transmitted pursuant to Section 19(d) of the Securities Exchange Act of 1934, Public Law 87-196.

I.

As directed by the Congress, the whole Report is a broad study of the securities markets and a commentary on the adequacy of investor protection in those markets. As we indicated in our first letter of transmittal, the Report demonstrates that, although serious problems do exist and additional controls and improvements are much needed, the regulatory pattern of the securities acts does not require dramatic reconstruction. In important respects this pattern has been effective, efficient, and adaptable; it has advanced and guarded investor participation in our economic growth. The functions of this Report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence.

1/ Copies of these four chapters, as well as of Chapters V, VI, VII and VIII submitted on July 17, 1963 (Release Nos. 28, 29, 30 and 31), will not be available for public distribution until they have been printed by the Government Printing Office (a further announcement will be made when they become available). Printed copies of the first four chapters of the Report are now available for purchase from the Superintendent of Documents, Government Printing Office, Washington, D. C., as Part 1 of House Document No. 95 ($2.25 per copy), and Chapter IX as Part 3 ($.50).

II.

The Chapters here submitted deal with diverse subjects, including the adequacy of the structures and practices of the self-regulatory agencies, security credit regulation, mutual fund selling practices, and events surrounding the market break of May 1962. As in the case of prior sections of the Report, the Special Study was given freedom to analyze and point out problems as they appeared to it; in this respect the judgments, analyses and recommendations in the Report are those of the Special Study and not the Commission. We strongly endorse the general soundness of these Chapters as a basis for discussion with the industry, for rule making, and for legislative proposals. Without public notice and comment, we may not speak definitively on those questions involving substantive changes in our rules or the rules of the self-regulatory agencies. In any case, we believe the responsible course of action calls for discussions with the securities industry before final decisions are made.

Rather than taking up the Chapters in order, we shall first focus on Chapter XII--which analyzes the role of the self-regulatory institutions and their relation to the Commission.

A.

In Section 19(d) of the Securities Exchange Act, the authorizing resolution for the Special Study, the Congress emphasized an examination of the adequacy of the rules of the self-regulatory agencies. The whole Report is a comment on this theme. Chapter II evaluates the rules of the NASD and of the principal exchanges relating to qualifications and Chapter III those governing selling practices and investment advice. Chapters VI and VII examine the rules and procedures of the self-regulatory agencies with respect to trading practices in the exchanges and over-the-counter market. Chapter XII, transmitted today, analyzes the organization and self-regulatory operation of those agencies, with primary emphasis on the New York Stock Exchange and the National Association of Securities Dealers, Inc., and their relationship to the Commission and each other.

We agree with the Report that "the basic statutory design of substantial reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas." This conclusion obviously does not minimize in any way the need promptly to remedy the disclosed inadequacies, a need more critical as increased reliance is placed on the self-regulatory agencies--which this Report and the Commission contemplate.

1.

The New York Stock Exchange occupies an unrivalled position as a self-regulatory institution because of its importance as a market and because of the dominant position of its membership in the securities business. We believe it important to point out, first, that the Study quite properly devoted particular attention to problem areas and, secondly, that, although there are defects in the functioning of the Exchange market which should be corrected, the Exchange has worked diligently, and on the whole successfully, to maintain a fair and honest market. The Report points out the strong performance of the Exchange in many areas, including qualifications and net capital. Its disclosure, and related requirements, some antedating the enactment of the Federal securities laws, represent a major contribution to investor protection and, in some respects, have gone beyond anything the Commission could do. In certain areas, judged by the Exchange's own standards of accomplishment, performance has been less satisfactory. For example, controls over branch office operations and investment advisory and selling practices require strengthening; the Exchange itself has recognized this in its initiation of new programs. The Report discloses a failure of regulation over odd-lot dealers, and raises serious questions about floor-trading. The Special Study's examination of the Exchange's specialist system reveals no widespread abuses or patterns of illegality. On the other hand, there are subtle and complex problems discussed in the Report which call for examination and review by the Exchange and the Commission with a view to strengthening the system and raising the quality of operation of some segments to that of the most effective and most efficient.

Moreover, disciplinary action does not appear to have been as forceful as circumstances have warranted. With regard to the organization of the Exchange, the Report points to a need for a reallocation of voting power among members and allied members in order to give firms dealing with the public more responsibility in the government of the Exchange.

The importance of the New York Stock Exchange as a self-regulatory institution and as a market makes it imperative that it bring its entire level of performance up to its demonstrated capabilities. The recommendations in Chapter XII-B of the Report and elsewhere are designed, as the Report states, "to point toward an even stronger future role" for the Exchange. With limited reservations in two instances which are footnoted below, we agree with these recommendations.*

2.

Early in 1962 the Division of Trading and Exchanges of the Commission, in conjunction with the Special Study of Securities Markets, issued a report concerning the American Stock Exchange. This report pointed out serious problems in regard to the operations of that Exchange and practices occurring on its floor. The American Stock Exchange, together with selected representatives from the securities industry, and in consultation with the Commission, has since engaged in a substantial reorganization of its management, constitution and operations. As the Report concluded in subchapter XII-C: "In contrast to the prior breakdown of self-regulation described in the staff report, the accomplishment of this reform appears to be an excellent demonstration of the effectiveness of self-regulation under responsible Exchange leadership and active Commission oversight." It is apparent that the American Stock Exchange has now instituted a responsible regulatory system as a basis for meeting its obligations under the Exchange Act, including problems it shares with the NYSE.

The Special Study made a more limited examination of the regional exchanges, with primary emphasis on the Midwest and Pacific Coast Stock Exchanges--the major regional exchanges. We agree with the recommendations with respect to these exchanges in subchapters XII-D, E, and F of the Report.

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* As to the recommendations in Item 2, we favor steps looking towards a more representative distribution of voting power among regular and allied members. We will explore further the need for altering the composition of the governing bodies of the Exchange. With respect to Item 7, the obligation of the Exchange, of which it is not unmindful, to avoid exaggerations and misunderstandings in its advertisements is clear. Whether any further restrictions should be placed on the Exchange's public relations activities is not so clear. The Commission has encouraged the Exchange to undertake the supervision of the advertising of its member firms, including advertising of an institutional character, some of which is the work product of the Exchange's own staff. The Commission is not now prepared to dispense with the advantages of the present system without further examination of the problem.

3.

The primary responsibility of the National Association of Securities Dealers, Inc., is to regulate the conduct of its members in the over-the-counter market. Because the over-the-counter market is scattered throughout the country, includes all varieties of securities, and is open to all persons, the NASD's job is a difficult one. Its role will become more important, since many recommendations in the Report call for increased activity on the part of the NASD in both policy making and enforcement.

The work of the NASD is in large measure performed by its members who volunteer their time and effort to the job of self-regulation. The NASD has established important standards of business conduct, including restrictions against unconscionable underwriting compensation and rules dealing with "free-riding". It has assisted in the general enforcement efforts against over-reaching and abuses in the over-the-counter market. However, there are many key areas in need of improvement in the over-the-counter market, in terms of new standards, as well as strengthened enforcement programs. In this context, certain organizational characteristics, including the emphasis on member participation and the heavy demands on the Board of Governors necessitate significant rethinking and redirection. More effective regulation requires a larger staff--a direction in which the NASD has been moving during the last few years--with increased responsibility and a reallocation of work among member participants in the government of the NASD. The participants would then have more opportunity to consider general policy and the NASD could better carry its formidable workload.

We agree with all of the recommendations of the Report in subchapter XII-G which are designed to strengthen the organization of the NASD and make its operations more effective.

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The fundamental issue of the relationship between the Commission and the self-regulatory agencies requires special comment. The Report states in Chapter XII-I that "regulation in the area of securities should, in short, be a cooperative effort, with the government fostering maximum self-regulatory responsibility, overseeing its exercise, and standing ready to regulate directly where and as circumstances may require." We subscribe to this statement of policy and generally agree with the specific recommendations in Chapter XII-I. The obligations of the self-regulatory agencies should be increased, through both their adoption of rules in many areas and their assumption of new enforcement duties--including certain duties now borne by the Commission.

The failure of the self-regulatory agencies to operate at maximum capacity and with full regard for the public interest in certain areas is in part attributable to the Commission's own failure to provide the necessary continuing guidance and oversight. We are certain that the present statutory pattern permits more effective and more pervasive self-regulation than has yet been achieved. Undoubtedly this will require a reorientation of our present procedures in the directions suggested by the Report's recommendations. For example, under Section 19(b) of the Exchange Act, we have a duty to review exchange rules to determine whether they are consistent with the protection of investors. We should place more emphasis on newly adopted rules than is now the case. Thus, our present arrangements with regard to the exchanges' notification to us of rule changes prior to their adoption might be revamped along the lines of the procedures worked out with the New York Stock Exchange respecting changes in the minimum commission rate schedule. With respect to the NASD, our authority to alter or amend their rules is more limited than in the case of the exchanges. We have, however, direct powers over practices in the over-the-counter market, in many respect unexercised, which can be utilized. Until these have been fully exercised and found wanting, we shall not ask Congress for legislation. In any event, up to this time needed improvements have been secured after conferences and discussions with the NASD.

We shall examine with the exchanges the need for further procedural safeguards for those affected by exchange actions--a problem that has taken on new significance because of the recent Supreme Court case of Silver v. New York Stock Exchange. In addition, as suggested by both subchapters XII-I and XII-J, we will confer with the self-regulatory agencies to determine methods by which enforcement and inspection responsibilities can be better allocated between the Commission and the self-regulatory agencies and among those agencies themselves.

One sector of the self-regulatory scheme will require joint analysis with the exchanges of the need for legislation. In the Silver case the Supreme Court held that the termination, at the order of the New York Stock Exchange, of wire service from its members to a non-member, without any hearing afforded the non-member, involved a violation of the antitrust laws.

We believe it essential that the Silver decision should in no way be construed to inhibit vigorous performance by the exchanges of their self-regulatory responsibilities. We are confident that the Supreme Court intended no such result: indeed the Court emphasized "the federally mandated duty of self-policing by exchanges." Steps can and must be taken to avoid any possible problems. These could include appropriate procedural changes by the exchanges and careful analysis of the need for some form of review of exchange actions by the Commission. If review procedures are thought necessary, legislation may be required.

Our firm conviction is that self-regulation, an essential ingredient in investor protection, must continue in a strong, forward movement. Accordingly, we have written to the New York Stock Exchange advising of our concern and shall undertake to resolve with it any problems presented by the Silver case.

B.

In Chapter X, the Report has examined security credit regulation as a factor in the securities markets. This regulation, of course, has broader aims: it is an instrument for credit control in the economy. As such, it is the primary concern of the Board of Governors of the Federal Reserve System. Accordingly, as the Special Study has pointed out, recommendations in this area including legislative proposals relate essentially to matters within the jurisdiction of the Board of Governors. The Commission believes that all the recommendations of the Study have merit, but, recognizing the paramount authority of the Board, will not initiate any action. We shall work closely with the Board towards the resolution of the problems raised.

The staff of the Special Study received generous assistance and cooperation from the staff of the Board of Governors who reviewed Chapter X from a technical point of view and who also prepared all of the appendices. Of course, none of the Reserve personnel, nor the Board, is in any way responsible for the final views expressed in the Chapter.

C.

Chapter XI of the Study deals with selected aspects of open-end investment companies, so-called "mutual funds," including selling practices, contractual plans, insider trading in portfolio securities and portfolio-brokerage reciprocal business patterns. It must be emphasized that this Chapter should in no way be construed as a reflection upon the investment merits of mutual fund shares, upon the investment company as an important vehicle for investment, or upon any particular company. Furthermore, it should also be emphasized that the questions raised with respect to contractual plans do not, and should not, affect present holders of these plans. As the Study has stated, its analysis should not be taken by any planholder as a reason for redeeming any plan certificates. Early redemption of a plan almost invariably results in loss to the planholder. The problems analyzed by the Report are in no way related to the merits of the underlying investments or to shares bought outright. The recommendations are focused solely on future contractual plans as distinguished from plans already entered into.

Contractual plans involve the purchase of mutual funds on an installment basis, with a substantial portion of the sales load--up to fifty percent--taken out in the first year. Their sponsors justify this deduction on the ground that it provides a necessary stimulant to saving. The Report has raised serious questions about contractual plans, basically revolving around the first year sales load deduction. As Chapter XI-B recommends, steps should be taken to deal with the problems disclosed. Discussions will commence with the industry immediately; but definitive action, whether legislation or otherwise, will await the completion of our general structural study of mutual funds.

In Chapter XI the Report also analyzes mutual fund selling practices, reciprocal business activities, and potential conflicts of interest related to insider trading in fund portfolio securities. With the limitations footnoted below, we agree with the accompanying recommendations.*

As the Congress is aware, on August 27, 1962 the Commission transmitted to the Congress "A Study of Mutual Funds", representing a fact-finding survey of certain aspects and practices of open-end investment companies. This Study was prepared by the Wharton School of Finance and Commerce of the University of Pennsylvania. At the same time, the Commission requested its Division of Corporate Regulation to undertake a detailed analysis of the Wharton School Study and conduct its own examination into structural problems of mutual funds. That examination should be submitted to the Commission some time late this year or early in 1964. Meanwhile, Chapter XI of the Report represents an important contribution to the overall picture.

D.

Chapter XIII of the Report deals with the events surrounding the severe market break of May 1962. This Chapter was specifically promised at a Congressional hearing. The Report draws upon data collected by the New York Stock Exchange and also its study of May 28, 29 and 31. The Report presents additional data with respect to transactions by institutions, foreign investors, and members and also an analysis of transactions in selected stocks.

As pointed out in subchapter XIII-E, neither the Report of the Study nor that of the New York Stock Exchange was able to isolate and identify the causes of the market events of May 28, 29 and 31. Moreover, contrary to some speculation at the time that the events might be the result of some conspiracy, neither of these Reports presents any evidence that the break was deliberately precipitated by any group or resulted from manipulation or illegal conduct in the functioning of the market.

The Study--after noting the extreme nature of any action by the Commission suspending trading under Section 19(a)(4)--recommends that the Commission and the industry should make a joint study of possible measures which might be taken by the Exchange "to assure minimum disruption of the fair and orderly functioning of the securities markets. . ." We interpret this to mean measures to improve the efficiency and effectiveness of the operations of market mechanisms during periods of severe market stress.

The Exchange, of course, has at its disposal a number of measures to deal with unusual conditions in the market place and invokes these from time to time on a security-by-security basis as, for example, the controls exercised over "openings" and the temporary suspension of trading in particular securities.

The Special Study was not able to address itself to the manner in which these measures were or might have been employed with particular reference to the events of May 28-31. The material published by the Stock Exchange likewise does not deal with this specific question.

The various recommendations made elsewhere in the Report, in part upon the basis of data relating to the market break, with respect to such matters as short selling, the capital position of specialists, floor trading and odd-lot transactions, should improve the ability of the mechanism to function more effectively in normal periods as well as in times of stress. It seems clear that, in the course of our consideration of these matters with the Exchange, events leading up to and during the market break must inevitably

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* With respect to Item 2, subchapter XI-B we shall examine various ways by which our prospectus requirements for mutual funds can be further refined. Finally, with respect to the recommendation of subchapter XI-D, we believe that each registered investment company should adopt, and take appropriate steps to enforce, a written policy concerning insider trading along the lines suggested in this recommendation.

join the considerable array of complex and, to some degree, technical factors which must be weighed in reaching decisions. We agree that it would be desirable for the Exchange to review the data accumulated in the course of the two studies, with particular reference to whether the procedures available to it were employed always as fully or as effectively as they might or should have been and whether sound policy would suggest some changes, and whether it is feasible or necessary to obtain additional trading information. The results of this review could thus be available to assist both the Exchange and the Commission in seeking solutions to some of the problems described in the Report. Certainly, it would seem that the performance of some specialists during the market break was not considered satisfactory by the Exchange itself; moreover, it is not clear why the machinery for handling some odd-lot orders should have failed as it apparently did. These and similar matters deserve the particular attention of the Exchange and of the Commission in the exercise of its oversight. It should be kept in mind that the role of the Commission, and that of the Exchange, does not extend to "managing" price movements or purposefully affecting prices.

III.

This transmittal completes the Report of the Special Study of Securities Markets. The Report is clearly the most thorough examination of the securities markets since the early 1930s. Size alone is but a poor measure of its importance and achievement. The Report would have high usefulness if only for its orderly presentation of basic facts about the markets. More importantly it offers a foundation for regulatory and industry actions for a long period to come.

Implementation of the Report can be prompt in many cases. Fundamental recommendations of the Special Study have already been incorporated in the Commission's legislative proposals, embodied in S. 1642, as amended, H.R. 6789 and H.R. 6793. S. 1642, as amended, has passed the Senate and, together with H.R. 6789 and 6793, is now pending before the House of Representatives. It is our judgment that these bills represent essential amendments to the securities laws. By providing for more reliable and extensive disclosure as to companies traded in the over-the-counter market and by raising qualification standards for those dealing in over-the-counter securities, enactment of the bills will have a pervasive impact on the raising of standards in the securities markets and will serve as a base to achieve many of the improvements suggested by the Study. At the same time, as we noted in connection with the transmission of Chapters V through VIII, the legislative program stands by itself; thus consideration of the bills can appropriately proceed independently of the discussion and resolution of the questions raised in the chapters here transmitted.

Finally, we do not plan to submit any further legislative proposals to the Congress this session. We may at a later session recommend legislation relating to quotations bureaus and to review of exchange actions--the latter only if it is found necessary after further analysis of the Silver case. Furthermore, we shall work with the Federal Reserve Board in any program respecting security credit regulation which they believe should be submitted to Congress.

In addition to our legislative proposals, substantial benefits have resulted since the institution of the Study. Some of these are summarized in subchapters XII-B and XII-G. Many more will result as the Report is carefully and selectively implemented. We will work expeditiously and in conjunction with the securities industry on the numerous recommendations requiring rule making on our part and on the part of the industry agencies. Certain areas, such as the impact of automation on the securities industry, are clearly long-range in nature and require continuing and elaborate analysis before decisions can be reached.

IV.

In measuring others, we must measure ourselves. As we said in our first letter of transmittal, while the Report focuses upon the shortcomings in the industry and in the self-regulatory agencies, in certain respects it is an express or implied criticism of the Commission as an institution. For example, on the exchange side, the failure to regulate odd-lot activities and, on the over-the-counter side, the lack of more specific standards and of more effective enforcement procedures in certain sectors represent problems unsatisfactorily resolved by the Commission. We have at times been hampered by a lack of personnel or concentrated on particular areas. Further, we, like the self-regulators, have been preoccupied with day-to-day problems and have not been able fully to perceive new trends and weaknesses which arose with the expansion of the securities markets--an occurrence in itself intensifying the routine administrative tasks as well as creating new problem areas. However, institutions--government, quasi-public or private--all benefit from re-examination. It has required a Special Study,detached from involvement with routine, but necessary, tasks, to produce a comprehensive, over-all view of securities regulation. But what we have done is not so important as what we must do--and that must be the case with the self-regulatory agencies and the financial community as well.

In concluding,the Commission would again like to acknowledge the cooperation offered throughout the conduct of the Study by members of the securities industry, by the self-regulatory agencies and by others in government. We once more express our appreciation for the extraordinary work of the staff of the Special Study of Securities Markets under the leadership of Milton H. Cohen as Director, Ralph S. Saul as Associate Director, Richard H. Paul as Chief Counsel, Sidney M. Robbins as Chief Economist, and Herbert G. Schick as Assistant Director. The staff of the Study has proceeded always in a responsible, thorough and craftsmanlike manner. We have indeed been fortunate to have retained the services of so many dedicated individuals from private law practice and industry, from the universities, from government and from our regular staff. We are also grateful to the many in our operating divisions and offices who contributed much to the Study in ideas, experience and information.

We believe that the Study has fully justified the confidence entrusted in the Commission by the Congress in authorizing an examination of the securities markets.

By direction of the Commission.

Special Study Transmittal Letter

The text of the transmittal letter from the Special Study to the Commission, signed by Milton H. Cohen, Director, Ralph S. Saul, Associate Director, Richard H. Paul, Chief Counsel, Sidney M. Robbins, Chief Economist, and Herbert G. Schick, reads as follows:

"We have the honor to transmit herewith the final four chapters--X, XI, XII and XIII--of the Report of the Special Study of Securities Markets. (In our transmittal letter of April 3, 1963 we referred to a possible Chapter XIV to cover topics that might not fit within the scope of any of the other chapters or within the limits of later transmittal letters. It has not been found necessary to have a separate Chapter XIV.)

"In our two previous transmittal letters, we have made some general comments about the nature of the Study and of our findings. These were intended to apply to the entire Report and we find no reason to modify them at this time. The following paragraphs from our letter of April 3 should have re-emphasis as we complete the Report:

'The enormous growth of the securities markets experienced since the original enactment of the federal securities laws, reflecting both the vigor of the industry's own activities and the general expansion of the country's economy and population in the intervening years, has been accompanied by many qualitative changes in methods, practices, controls and standards. A basic objective of the Special Study was an evaluation, in the light of both quantitative and qualitative changes, of the theories and mechanics of direct governmental regulation and industry self-regulation originally envisaged by those laws. The Study and Report indicate that under the stresses of its expanded role the framework of regulation needs considerable adjusting and strengthening, but its basic design appears to have stood the test of time and to have worked effectively in most areas.

'Since the federal securities laws have been in force for a full generation, it is hardly surprising that the Special Study has not disclosed the prevalence of gross abuses such as were characteristic of the era which preceded their enactment. Nevertheless, as will be evident from the entire Report, many serious problems do exist and important improvements are needed. It is inevitable that in reflecting the results of any investigation, a final report will give greatest attention to the problems uncovered and the areas in which the need for improvement is most pressing. Nevertheless, the emphasis in this Report on present shortcomings should neither obscure nor detract from the many aspects of the securities business and its regulation and self-regulation which afford reason for pride and satisfaction. The strength of the American economy and its free-enterprise system both reflect and are dependent upon an investment banking system and market institutions that are basically strong and sound, but this makes it all the more, rather than less, necessary to expose and correct the weaknesses and abuses that still exist. Many of the substantive recommendations in the Report can, indeed, be regarded as attempts to raise the entire securities industry to the best standards which the industry itself proclaims and to the highest levels of attainment which some of its participants have in some sectors achieved.'

"The chapters first transmitted (I-IV and IX) called for certain legislative solutions and these have been substantially embodied in S. 1642, recently passed by the Senate, and in the pending bills H.R. 6789 and 6793. The second group of chapters (V-VIII) essentially called for only one item of legislation--authority to regulate over-the-counter quotations systems. As to the present group of chapters: Chapter X, dealing with security credit, would require statutory changes if the Federal Reserve Board and the Commission subscribe to certain of our substantive recommendations. Chapter XI, relating to mutual funds, would call for a legislative solution in respect of so-called contractual plans, but in this instance we have assumed that the formulation of a legislative program will await completion of the Commission's other pending studies regarding structural aspects of mutual funds. With regard to Chapter XII, dealing with the self-regulatory and regulatory pattern, various statutory changes would unquestionably contribute to a more complete and logical pattern of relationships between the Commission and the various self-regulatory agencies and at the same time might be the most direct means of resolving issues presented by the case of Silver v. New York Stock Exchange. On the other hand, we are not prepared to say, in the absence of a more detailed legal analysis than we have been able to make, that the Commission's present broad statutory powers would not be adequate for all purposes indicated in the chapter, and accordingly we make no specific legislative recommendation in this area. Chapter XIII, relating to the 1962 market break, likewise does not contain any recommendation for legislation.

"It should be emphasized, in any event, that any questions of legislation arising out of the present group of chapters are quite separate from the matters covered in our prior legislative recommendations as embodied in the bills now pending, i.e., qualifications for entry into the securities business and disclosures for over-the-counter securities. Nothing in our later studies or analyses has in the slightest degree shaken our conviction that the latter subjects of legislation are basic and urgent, both in their own right and as foundations for other improvements in rules and practices in the securities markets.

"The legislative recommendations of the total Report are relatively few, not because there is little to be done, but because most of what we recommend can in all likelihood be accomplished under existing powers of the Commission and the self-regulatory agencies. The total Report constitutes not only a comprehensive factual presentation but also a major agenda for action by the Commission and the industry groups to correct the shortcomings in the market and regulatory mechanisms that have been disclosed.

. . . .

"In our prior transmittal letters we expressed appreciation for the contributions of the groups and individuals, within and outside the Special Study staff, who have importantly contributed to the work of the Special Study. Without repeating their names, we again express appreciation for the loyal and devoted efforts of the very competent group who served directly on the Study staff and for the indispensable assistance and cooperation received from others, including the members of the Commission, members of the staff of other divisions, other governmental and private agencies, and, by no means least, individuals and firms in the securities business and their self-regulatory institutions. Our previous letter neglected to mention the valuable assistance received from Joseph A. Keenan, Jr. of the Division of Trading and Exchanges.

"Our previous letter incorrectly listed Bernard H. Garil as a member of the clerical staff rather than as a financial analyst, and omitted mention of Gerald L. Feigen, who served on the Study's staff as a financial analyst.

"Having been stationed at the Commission's office facilities at its headquarters in Washington, we can not refrain from commenting on these facilities. The Commission is a permanent, important agency of the United States Government, in existence since 1934, yet it still has its headquarters in a "temporary" building and annexes whose many inadequacies, inconveniences and discomforts cannot but impair the efficiency of its operation and even hamper its efforts to recruit and retain needed personnel. In the name of good government, the Commission urgently needs a more business-like office where its personnel may do their work efficiently, comfortably and pridefully.

. . . .

"As the Special Study leaves the scene, others must assume the large responsibility of converting recommendations into programs of action. In the long run we are confident that the information, analyses and recommendations that have been produced by the Special Study will improve the operation of the securities markets, produce a healthier securities business, and provide stronger safeguards for the investors of the nation."

CHAPTER X

SECURITY CREDIT

In Chapter X of the Report of the Special Study of Securities Markets of the Securities and Exchange Commission, filed with Congress today, the Special Study analyzes existing controls on "security credit," which is defined in the Report as credit extended either for the purpose of purchasing or carrying securities or credit which is collateralized by securities. Recommendations are made for amendments to provisions of the Securities Exchange Act of 1934 respecting security credit and to the implementing regulations of the Board of Governors of the Federal Reserve System (FRB). The most important of these recommendations, if adopted, would provide for the extension of initial margin requirements to some "non-purpose" loans, i.e., those for a purpose other than purchasing or carrying securities; permitting broker-dealers to extend credit on certain unlisted stocks and convertible bonds; requiring banks to impose initial margin requirements on certain unlisted stocks and convertible bonds used as collateral for loans; and the regulation of some persons in the business of extending security credit who are presently "unregulated lenders."

The Report emphasizes that the primary responsibility for promulgating credit controls is a function of the FRB. The Exchange Act gives the FRB power to control the use of credit for the purchase or carrying of securities while the Commission has primary responsibility for enforcement of the Act and the FRB credit regulations. In the exercise of its authority under the Exchange Act, notes the Report, the Board has adopted Regulations T and U, relating respectively to broker-dealers and domestic banks. These regulations govern the initial extension of credit (these requirements, in effect, establish the amount of the down payment which a credit purchaser of securities must pay--commonly referred to as "margin") but do not regulate the amount of "margin" (i.e., equity) which must be maintained in borrowers' accounts. "Maintenance" requirements--the "margin" or equity that must be maintained in a customer's account--are imposed by the exchanges and by lenders themselves.

The Report states that the Special Study has limited its inquiry to the effect of security credit as a factor in the securities markets themselves. While recognizing this more limited concern of the Commission with security credit and its regulation, the Report states that, with respect to the relation of security credit to the securities markets, "it is believed appropriate to state conclusions and recommendations, notwithstanding that the recommendations relate essenially to matters in the jurisdiction of the Board of Governors."

The Report notes that certain information used in Chapter X was prepared by the staff of the FRB at the request of the Special Study. The conclusions and recommendations in the chapter, however, are made solely by the Special Study and do not purport to represent those of the FRB or its staff.

The Special Study examined margin calls (requests for additional collateral) by broker-dealers, banks, and lenders not directly subject to present FRB regulations during the market break of 1962. The evidence examined by the Study indicates that loans which were made with an initial margin requirement withstood the break well and that those free of such controls were much more vulnerable to margin calls.

The Report concludes that a substantial initial margin requirement in security credit transactions is a "strong defense" against forced liquidations of securities in a declining market. The Report states: "In periods of rising prices, an inadequate initial margin requirement might result in speculative excesses and untenable price levels. When prices decline, forced securities sales might turn an orderly market retreat into a rout."

The Report points out that there are a number of types of security credit transactions on which FRB regulations do not presently impose an initial margin requirement. One of these, notes the Report, is that existing for "non-purpose" loans. From a survey conducted by the FRB, it was estimated that member banks of the Federal Reserve System held $8.6 billion of stock-secured unregulated loans on September 26, 1962--the survey date. It was determined that "non-purpose" loans comprised $7.8 billion of the $8.6 billion of the unregulated loans while the remainder was composed of loans to purchase or carry securities which were not subject to margin controls. "The existence of a large amount of non-purpose loans," says the Study, "principally collateralized by stocks which could be carried on low margin and are readily subject to call during deteriorating markets must be regarded as a threat to market stability." The Report recommends that the Exchange Act be amended to give the FRB authority "to extend some kind and degree of margin control on all loans collateralized by securities whose forced liquidation in a declining market would have a significant market-disruptive potential, including some loans now classified as 'non-purpose,'" unless the Board of Governors itself feels that further studies are necessary before requesting such authority. The Report suggests that this authority should be sufficiently broad to encompass non-purpose loans collateralized by actively-traded securities and flexible enough to enable it to adjust initial margins with a view to meeting both the narrow and broader objectives of security credit control.

The Special Study notes that another distinction under existing security credit controls is that between the margin status accorded listed and unlisted securities. The Report points out that broker-dealers are entirely prohibited by the Exchange Act from lending on any collateral other than listed and "exempted" securities (principally U.S. government and state municipal obligations) for the purpose of purchasing or carrying any securities. Banks are permitted greater freedom of action: they may lend on unlisted as well as listed stocks up to the amount permitted by Regulation U(currently 50 percent of their market value), where the purpose is to purchase or carry listed stocks; they may lend any amount determined in good faith on collateral other than stocks to purchase or carry listed stocks; and where the purpose is to purchase or carry unlisted stocks, banks are not restricted by the Exchange Act in the amount they may lend, even if the collateral is listed stock.

The Report states that the differences in treatment under the Exchange Act between broker-dealers and banks were based primarily on the lack of reliable and current prices and the presumed illiquidity of over-the-counter issues in 1934 when the Act was adopted. It appears also to have resulted from the differing assessments of the economic roles of banks and broker-dealers. Banks, says the Report, tend to place greater reliance on the general credit-worthiness of borrowers than do broker-dealers, who may place principal reliance on the collateral and may be less likely to sell the collateral in the event of a decline in its market value. The Report notes that certain actively traded over-the-counter securities, however, may have the same outward characteristics as listed stocks, including price volatility, and that for this group, "the presumed illiquidity that influenced Congress in 1934 does not now, at least, obtain." These stocks are used in large volume to support bank loans to purchase or carry stocks. The Report recommends that margin controls under Regulation U be extended to at least a part of these stocks and to certain convertible bonds. This power should extend both to loans for purchasing or carrying securities and also for other purposes. It is not intended, the Report states, that such a requirement restrict banks from lending at their discretion, as at present, on inactively-traded over-the-counter stocks, convertible bonds, or non-equity securities. At the same time, the Report recommends that the prohibition against broker-dealers' lending on at least some over-the-counter stocks and convertible bonds be relaxed. The Report notes that the classes of over-the-counter stocks as to which broker-dealers would be permitted to extend security credit need not necessarily be the same as those on which such controls would be applied with respect to banks.

The Report also recommends that those bonds convertible into common stock selling at a price reflecting the conversion privilege be subject to initial margin requirements. It notes that these bonds provide an avenue to avoid security credit controls on the underlying stocks since banks are not limited in the amount which they may lend on the bonds. The Report also states that they are equity securities in their own right and may be subject to all of the market-disruptive potential of stocks.

The Report also discusses "unregulated lenders," a term defined by the Study to include "any person or firm, other than a domestic bank or a broker, lending money for the purpose of enabling the borrower to purchase or carry securities." These persons, including so-called "factors," are not now subject to any direct security credit controls although provisions of Regulation U may limit the amount which banks lend to them under certain circumstances.

The Report describes the operations of unregulated lenders in considerable detail. It notes that, while the sole or primary business of some is lending to purchase or carry securities, others are engaged primarily in other forms of commercial financing. Typically, they lend up to 90 percent on securities and charge from one to two percent interest per month on securities loans. Funds are obtained for lending either from the lenders' available capital or through loans from domestic banks or, in certain cases, from foreign sources.

All securities loans made by unregulated lenders are demand loans and the turnover appears to be very rapid. Among the unregulated lenders interviewed by the Special Study, it was uncommon for any such loan to be outstanding for more than six months and the average period was one month. According to the Report the bulk of borrowing appears to be on active listed securities.

It is extremely difficult to determine the aggregate amount of unregulated lending. The amount of such lending at any given time apparently varies considerably; it would seem, for example, that it was much higher during the bull market in 1961 than it was in 1962. The Report notes that although the volume of unregulated lending may be small in relation to all security credit, its effects may be far greater than either level would indicate. Loans are usually made to speculators on low initial margin; the loans are concentrated in a relatively few securities and the information gathered by the Special Study indicates that, during the market break, loans by unregulated lenders were the first to be called.

The Report concludes that "unregulated credit may...serve to undermine the broad objectives of the FRB with respect to security credit." It recommends that "all persons" making loans to United States residents, on the collateral of securities traded in United States markets, be subject to the same requirements as domestic banks, with appropriate exclusion for lenders in specified categories such as those not engaged in a business of lending or those never having aggregate outstanding security loans of more than a specified amount--say, $100,000. It also recommends that domestic lenders be required to keep specified records and file periodic reports and that domestic banks be prohibited from furnishing any form of assistance or service to any foreign lender in connection with any loan not in conformity with such requirements.

CHAPTER XI

OPEN-END INVESTMENT COMPANIES

(MUTUAL FUNDS)

In Chapter XI of the Report of the Special Study of Securities Markets, the Special Study discusses certain aspects of the mutual fund industry. These relate to selling practices of sales organizations specializing in mutual fund shares, special problems involved in the sale of contractual plans, the impact of portfolio-brokerage reciprocal business patterns on selling practices, and the area of potential conflicts of interest related to insider trading in fund portfolio securities. The Report observes that the Special Study has focused its attention in the investment company field on subjects outside the scope of the report of the Wharton School of Finance and Commerce, University of Pennsylvania, on the mutual fund industry transmitted by the Commission to Congress on August 27, 1962, and that various issues within the scope of the Wharton School study--such as relationships between the funds and their investment advisers and aspects of the management and underwriting structure--are currently the subject of a comprehensive program of study undertaken by the Commission's Division of Corporate Regulation.

The Special Study's investigation in the investment company field included interviews with industry personnel, some of whom also testified at the public hearings conducted by the Special Study, examination of industry training and selling literature, questionnaires, and a study of the payments record of a sample of contractual plan accounts. The Special Study also contracted with the Securities Research Unit of the Wharton School to conduct an independent survey of the characteristics and motivations of mutual fund investors.

The Report emphasizes that the Special Study was not concerned with and has not attempted to evaluate the merits of mutual fund shares as an investment medium, and that the Report should not be construed as endorsing or criticizing investment company shares generally or those of any particular company, or as a basis for purchasing or redeeming any such shares.

Sales Practices and the Special Problems of Contractual Plans

The Report notes that "certain factors peculiar to the mutual fund industry create pressures toward undesirable selling practices" and that "evidence suggests the existence of such practices to an unfortunate degree." It recommends that industry representatives and the National Association of Securities Dealers, Inc., in consultation with the Commission, jointly undertake a program designed to eliminate undesirable practices; it comments on the desirability of the further development of supervisory controls by industry members; and it urges the NASD to increase its activities in the surveillance of selling practices outside the area of advertising and sales literature. These recommendations, the Report notes, supplement the recommendations made in Chapter II, transmitted by the Commission to Congress on April 3, which are reflected in proposed legislation currently under consideration by the Congress, concerning registration of salesmen, improvements in their qualifications, and the proposal that all mutual fund selling organizations be required to join a registered securities dealers organization.

The Special Study also recommends that the Commission's prospectus requirements be further refined "to assure that basic information is brought clearly and conspicuously to the attention of the prospective investor." It would require a summary on the cover or beginning of each prospectus of the sales charges, expense ratios, advisory fees, performance objectives, and other basic information, and the disclosure of any "special or extra compensation arrangements for the sale of particular funds by mutual fund salesmen or of the fact that the salesman can only offer a particular fund or funds." In addition the Report recommends that the Commission consider exercising its rule-making power to define deceptive practices in connection with recommendations by salesmen to investors to switch from one mutual fund to another.

As to the sale of so-called contractual plans, the Special Study Report notes that the front-end load structure, under which a substantial portion of the total sales charge is deducted from the first installments paid on a long term investment plan, creates special problems "which cannot be solved through the mere application of the doctrines of disclosure." It concludes: "In conjunction with its comprehensive program of study of the investment company industry, the Commission should recommend to the Congress legislation amending the present provisions of the Investment Company Act of 1940 which relate to contractual plans. Consideration should be given to the abolition of any future front-end load. If it should be concluded that such abolition is not called for, such legislation should both substantially limit the amount and method of application of any such load and prohibit the offering of front-end load contractual plans by any mutual fund sales organization without the simultaneous offering of a level-load voluntary plan for shares of the same fund and (except for prepayment of selling charges) on substantially the same basis."

The Report cautions that its analysis of the problems involved in contractual plans should not be taken by any contractual planholder as a reason for redeeming any plan certificates, nor be misconstrued as criticism of the value of the underlying securities purchased through the plans, as to which the Study takes no position. Early redemptions of contractual plans almost inevitably result in losses to the planholders, and the Study notes that the questions raised by it should not lead investors to incur losses on investments in front-end load plans already made. They are rather addressed, the Report states, "to the issue of whether (or the conditions under which) contractual plans should be permitted to be sold in the future."

In its general discussion of sales practices in the mutual fund industry, the Report observes that the industry has experienced tremendous growth since 1941 (over 5,000 percent in total net assets and 2,000 percent in shareholder accounts). About half the growth in assets has resulted from the sale of new shares. The Report comments that several unique aspects of the marketing system and management structure of the mutual fund industry produce continuous pressures for growth and bring more intense sales pressures than is true of the securities business as a whole. These include the compensation arrangements among fund managers and underwriters, the continuous offering of fund shares under a fair-trade type of retail price maintenance, and a sales charge paid only by the purchaser, with no part borne by the fund. The Study notes that its description of selling organizations, selling practices, and training and supervision of salesmen applies principally, although with significant exceptions, to the sales organizations specializing in mutual fund shares. Sales of no-load funds, explains the Report, are handled without the use of such sales organizations as are described in the Chapter.

Large sized firms specializing in the sale of mutual fund shares and contractual plans, according to the Study, account for a high proportion of all contractual plan sales and a majority of the gross income earned by firms specializing in mutual fund sales. These large firms, the Report notes, have evolved a fairly distinct pattern of selling practices. There is a high turnover of mutual fund salesmen, and recruits are drawn overwhelmingly from persons totally inexperienced in the securities business. The new salesman generally is given only brief training before being sent out to sell mutual fund shares and contractual plans to the public. His first sales are generally made to prospects from his personal circle of acquaintances. In prospecting for new customers he frequently represents himself as an expert in financial planning despite his lack of background in the securities field and the brevity of his training. The Report notes that the extent of financial planning generally performed by a fund salesman is largely limited to persuading a prospect to invest a portion of his assets or earnings in mutual funds. The Study found that with respect to many mutual fund retailers specializing in the sale of mutual plans "the sales presentation is expected to be highly emotional and dramatic in tone, playing on such factors as fear, pride and patriotism."

Various observations concerning the contractual plan purchasers of mutual fund shares are set forth in the Report's summary of the results of an independent survey of mutual fund investors by the Wharton School, a copy of which is released as an appendix to the Report. The survey describes the "typical" mutual fund and contractual plan purchaser as a man in his middle to late forties, married, with three dependents, a high school education, a job paying an annual income of $5,000 to $10,000, and life insurance of $10,000 to $15,000. However, it also notes a general tendency for the proportion of contractual plan purchasers to rise, as levels of education, income and occupational skills decline. Among contractual planholders redeeming their accounts, the survey notes a substantial proportion in low income brackets and finds contractual planholders' utilization of their plans as a source of "rainy-day" savings to be clearly evident, although such plans may be unsuitable for this purpose because of the penalty resulting from the front-end load. While emphasizing the lack of comparative data for investors in other media, the survey notes the low level of knowledge of mutual fund shareholders regarding their funds. In the light of the indications of lack of sophistication on the part of mutual fund investors, the survey suggests that additional safeguards may be required for their protection.

In discussing the supervision of mutual fund salesmen, the Report observes that, as in the case of the securities industry generally, certain recognized improper practices justify particular attention. Of principal concern, it states, is "high pressure selling," which may involve misleading representations to customers, the sale of shares or plans to persons for whom their purchase is unsuitable, or switching shareholders from one fund to another for the sake of the commission to the salesman. Since mutual fund salesmen generally sell away from their own offices and in the offices or homes of their customers, and generally sell to new customers rather than to an existing clientele, their supervision presents unusual problems.

The Report notes that the stimuli which the structural elements of the mutual fund industry give to sales reach their quintessence in the sale of "contractual plans." These are essentially a long-term program for investing in mutual fund shares on an installment basis, with the unique feature that a substantial part of the total sales charge is required to be paid in connection with early payments as a "front-end load." Another method of systematically investing in mutual funds is the so-called "voluntary" plan. The main distinction between the two types of accumulation plans is that in the voluntary plan the sales charge, usually about 8 1/2 percent, is spread evenly over all the payments, while in the contractual plan half or more of the total sales charges is deducted from the first 13 installments. The Report states with respect to the contractual plan that: "The substantial commission which a salesman receives from the initial 13 payments, particularly when the purchaser prepays a number of them as he is usually urged to do, gives the salesman a strong incentive to sell these plans regardless of the circumstances of the purchaser in order to realize on at least the front-end portion of the load."

In a separate section on the special problems of contractual plan sales, the Report reviews arguments and statistics utilized by the industry to justify the use of the front-end load, and presents further statistics compiled by the Special Study on the payment performances of a sample of contractual planholders who purchased plans in February 1959. The Study's examination of these contractual plan accounts showed that three and one half years after the date of purchase, over 35 percent of all plans had been redeemed or had "lapsed" because no payment was made for at least the last 12 months. It found that about half of these, or 1/6 of all accounts, had paid an effective sales load of 50 percent of the amount they paid (equal to 100 percent of the amount invested), and the other half, an additional 1/6 of all accounts, had paid an effective sales load in excess of 18 percent, twice the maximum 9 percent overall charge permitted under the Investment Company Act. Further, states the Report, "It is the front-end load structure itself and the economic incentives which it gives to salesmen which are responsible for the failure of the disclosure concept adequately to protect the public from untoward selling pressures in contractual plan sales. Under these circumstances only compelling reasons can justify the continued existence of the front-end load. The Study has concluded that the justifications advanced by the industry are hardly persuasive and certainly not compelling." In view of the continuing study of the mutual fund industry by the Commission's Division of Corporate Regulation, the Study states that it would be premature to make a definitive recommendation, but concludes that "serious consideration should be given to the elimination of the future front-end load plans," and that in any event the structure of the front-end load should be fundamentally altered.

Reciprocal Business Practices

In a section of the Special Study Report dealing with reciprocal business practices and the problems of allocating mutual fund portfolio brokerage, the Report discusses the intricacies of these practices and their impact on the relationships of mutual funds and the organizations which sell them.

Reciprocity, or "doing business with people who do business with you," the Study observes, is an accepted custom of the business world in general and the securities industry is no exception. However, the Report states, in the mutual fund industry it takes on a unique characteristic for "while it is the mutual funds themselves whose portfolio transactions provide the brokerage which constitutes the currency of reciprocity, its principal beneficiaries are not the funds but their investment advisers and principal underwriters."

The Report states that the large volume of transactions executed by mutual funds in the exchange markets are sufficiently profitable to the member firms which handle them that these firms are willing to "give-up," i.e., give away, roughly 60 percent of the commissions received by them pursuant to exchange minimum commission rate schedules. However, since exchange rules prevent the return of these amounts to the funds, they are given instead to other broker-dealers, primarily as additional compensation for sales of fund shares, but also in exchange for investment advice and research or statistical materials provided to the funds' investment advisors. Moreover, "the existence of substantial sums of fund portfolio brokerage available as extra compensation for the sale of fund shares can lead to undesirable sales pressures by fund retailers," the Study observes.

Without making quantitative determinations of the basis of reciprocal brokerage allocations, the Report reviews some of the intricate patterns of reciprocity created by the variable factors affecting allocation of mutual fund portfolio brokerage. These include the structure and size of the mutual fund sales organization and relationships between it, the fund, the principal underwriter and the investment adviser; the types of services performed by various broker-dealers (with particular reference to sales promotional material supplied by a limited number of NYSE member firms to nonmember firms); the choice of exchange markets available for execution of portfolio transactions; the membership or non-membership of retail broker-dealers in various exchanges; and the differences among broker-dealers in their ability to execute transactions.

The Report notes that a major reason for the failure of mutual funds to benefit directly from the allocation of their portfolio brokerage business is the NYSE's minimum commission rate schedule and anti-rebate rules, which make no provision for block discounts or similar advantages to those engaging in large transactions. "So long as the funds cannot themselves benefit from the economies created by their mass purchasing power," it states, "the complexities and potential problems of the third party beneficiary system will continue." It concludes that ultimately the solution of these problems lies at their source. It urges that in the consideration of any revision of the NYSE minimum commission rate schedule, as contemplated by Chapter VI of the Report, "the question of introducing some form of volume discount should be high on the agenda."

The Report goes on to observe, however, that while NYSE rules have created the basic reciprocal business patterns, the problems are not confined to the community of NYSE firms. Non-member firms are also eager for additional compensation for their sales of fund shares, and there have developed various intricate reciprocal business patterns which permit non-member firms to share the indirect benefit of exchange brokerage. These include such questionable practices as the use of give-ups or "interpositioning" on over-the-counter executions. Interpositioning is a device whereby a broker-dealer is inserted between the fund and the primary executing broker, in order to generate a mark-up or commission for the inserted broker-dealer. Such over-the-counter give-ups and interpositioning raise serious questions of conflict of interest, the Study observes, since in the over-the-counter markets where no minimum commission structure exists there is no reason why the fund and its shareholders rather than broker-dealers should not be entitled to the benefits of the lowest obtainable costs for executions. These practices are "in flagrant conflict with the duty of a fund and its adviser to obtain best terms in its securities transactions." The Study recommends that they be prohibited by amendment of the NASD Rules of Fair Practice.

Insider Trading in Portfolio Securities

In the final section of the Chapter dealing with mutual funds, the Special Study examines trading in mutual fund portfolio securities by insiders and the policies of the investment company complexes concerning this practice. It notes that despite the widespread industry view that it is unethical to take advantage of inside information for personal gain in advance of portfolio transactions, "fairly extensive trading in mutual fund portfolio transactions by insiders takes place," and substantial variations exist in company policies covering such trading and the manner of their enforcement.

A Special Study survey of insider trading practices was conducted covering 28 representative mutual funds whose assets at December 31, 1961 aggregated $5.2 billion. "Overwhelmingly," the Study notes, "the funds and their investment advisers reported the existence of policies which reflected in one way or another their awareness of the ethical problems involved." Nevertheless, over the 7 month period as many as 14.4 percent of the insiders studied traded in portfolio securities during the same period as the fund was executing transactions, and 8 percent traded within 15 days prior to the fund. In view of the extent of trading by insiders discovered by the Study, it was surprising, the Study states, that only one fund indicated knowledge of any violation of its policies, and that violation was said to be inadvertent.

The Special Study concludes that "considerably more attention to the subject of insider trading is called for on the part of the mutual fund industry and the Commission. The situation calls both for clarification and implementation of higher standards for the industry." Specifically it recommends that each registered investment company be required to adopt a written policy satisfactory to the Commission covering insider trading, and to report violations of such policy to the Commission. Minimum standards for an acceptable policy, the Study recommends, should include: broad coverage of officers, directors, substantial stockholders and investment advisory employees, with appropriate recognition of the problems of independent directors; prohibition of purchases or sales of securities within 30 days prior to or following the date of a portfolio transaction in the same security issue, subject to reasonable exceptions; a requirement that persons covered by the policy report transactions in portfolio securities to the investment company involved; and appropriate sanctions for violations.

CHAPTER XII

THE REGULATORY PATTERN

Chapter XII of the Report of the Special Study of Securities Markets focuses directly on the phenomenon of self-regulation, and on the separate self-regulatory agencies as such. The Report discusses and evaluates the role of the New York Stock Exchange, the National Association of Securities Dealers, Inc., the American Stock Exchange and, to a limited extent, the regional exchanges. It also discusses certain quasi-self-regulatory organizations and considers the total role of the Commission in the regulatory pattern. Finally, attention is devoted to the problem of coordinating regulatory efforts among the various agencies charged with regulatory responsibilities and, briefly, to the role of the States.

In an introductory to Chapter XII, the Report notes that securities regulation is unique in featuring self-regulation as an essential and officially sanctioned part of the regulatory pattern, and a major task of the Study has been to assess how that technique has met the demands placed upon it and to determine how it might be strengthened and improved to meet present and future needs.

The Report emphasizes that "the basic statutory design of statutory reliance on industry self-regulation appears to have stood the test of time and to have worked effectively in most areas." The Study's conclusion that the demonstrated strengths and benefits of self-regulation outweigh its disclosed inadequacies does not lessen the need for seeking remedies for the inadequacies. The Report also points out that "some of the difficulties experienced in self-regulatory efforts may leave their counterparts, in one form of degree or another, in the Commission's own performance of its role."

The New York Stock Exchange as a Self-Regulatory Institution

The Special Study examined the regulatory performance of the New York Stock Exchange, which is uniquely important as a self-regulatory agency not only because of its outstanding importance as a securities market but also because of the dominant position of its membership in the entire securities business. The Study observes that the quantity and quality of the NYSE's self-regulatory activities are the most important single measure of the accomplishments and limitations of the self-regulatory concept. The Study notes that the Exchange has conceived of its regulatory role very broadly and has addressed itself to one degree or another to the most important aspects of the securities business.

The Report states that the Exchange has provided vigorous leadership and produced excellent results in many areas. Nevertheless, its record is described as an "uneven" one. The Study concludes that the Exchange has fallen considerably short of its own best levels of achievement in many specific areas critically affecting the public, both in formulating rules and standards to meet changing needs and circumstances and also in providing effective enforcement of its rules and standards. The Report points out that, in discussing the shortcomings of the Exchange's self-regulatory performance, it is not intended to overshadow or disparage its record of accomplishment, but to point toward an even stronger future role. The Report observes that some of the problems of self-regulation have their counterparts in the Commission's performance of its total role.

The Study concludes that "there appears still to be a disproportionate influence of floor professionals in the government of the Exchange, stemming ultimately from the allocation of voting power in the Exchange's constitution." Only regular members, i.e., holders of "seats," are entitled to vote at Exchange elections and on matters requiring approval by a vote of the membership. The seat concept is described as having "deep roots, reflecting the original private-club concept of the Exchange." The Report comments that it is anomalous that voting power is so closely tied to floor participation that a firm whose function involves floor operations--the prime example of which is an odd-lot firm--must have seats, i.e., votes, in proportion to its floor business, whereas, on the other hand, a firm whose business is with the public and primarily away from the floor may build a far-flung exchange business around a single or very few seats. Thus, a commission firm with 49 branch offices has only one partner owning a seat, while there are specialist firms with as many as ten partners owning seats. The Report also notes that over 800 seats, or 60 percent, are held by members whose firms do 10 percent of public commission business, have 10 percent of the total registered representatives and 13 percent of the total branch offices.

The Report states that the floor professionals--specialists, odd-lot dealers and brokers and floor brokers--are not necessarily the most talented for administration or regulation or the most responsive to public needs, even though the nature of their operations requires them to own seats and to be at the Exchange during the working day. Office partners may be more sensitive to the public character of the Exchange and more cognizant of the needs of public investors even though they have fewer seats and little occasion to be in the actual marketplace. The Study recommends that the disproportionate influence of floor professionals in the government of the Exchange be corrected by extending full or partial voting rights to allied members, i.e., partners and voting stockholders of member organizations.

The Report points out that of 29 elected governors, 17 are required to be regular members and 14 are generally floor members. The floor members control the important Advisory Committee, while the Nominating Committee has twice as many regular as allied members. After noting that an increasing number of specialists have served as Exchange governors and floor officials in recent years the Study recommends that the composition of the Board of Governors, Advisory Committee, Nominating Committee, and other governing bodies be altered to give increased representation to firms without specialist affiliation doing business directly with the public.

The Study concludes that in most respects the organizational structure of the Exchange as a self-regulatory agency seems basically sound. In noting that the Board of Governors is the sole policy-making authority and repository of regulatory power, the Study observes that the chairman of the board plays an important part in the Exchange's disciplinary mechanism, particularly as to the supervision of floor conduct.

The staff of the Exchange, which is responsible to the president, the Exchange's chief executive officer and official representative in all public matters, administers the Exchange and was found by the Study to be generally of adequate size and quality. More specifically, the Report concludes that the Exchange staff responsible for regulating conduct off the floor has sufficient authority and responsibility to carry out its regulatory duties, but that floor regulation is complicated by the existence of the floor governors, who resemble in material respects the standing committees which governed the Exchange prior to the adoption of the reforms recommended by the Conway Committee in 1938. The Study points out that because the floor governors are considered experts on floor matters there has been a tendency for the staff and even the board to defer to the judgment of the floor governors or an individual floor governor in resolving specific questions, and the authority and responsibility of the staff with regard to floor matters have tended to be limited accordingly. The Report recommends that the role of the staff responsible for floor regulation should be strengthened in relation to the floor governors. Further, the recent action of the Exchange in giving the Floor Department greater authority should be expanded so that its role will be equivalent to that of the Department of Member Firms in respect of off-floor regulation.

The Report, in stating that "the Exchange's accomplishments impressively illustrate its ability and potential to raise industry and corporate standards," gives examples of the Exchange's initiative and effectiveness in taking hold of different kinds of regulatory problems. For instance, the Study concludes that the Exchange's contribution in respect of qualifications of those entering the securities business has been of a "high order"; the administration of its net capital rule has been "generally vigorous and resourceful"; and its promulgation and enforcement of controls relating to listed companies have significantly contributed to increased investor protection.

On the other hand, the Report states that Chapter XII and other chapters of the Report "reflect areas where the Exchange has been willing to accept the status quo uncritically, where it has failed to perceive new needs for self-regulatory intervention, or where its intervention has been half-hearted or its methods have become outmoded." In observing that the Exchange's leadership has been much less noticeable and its accomplishments much less noteworthy in respect of selling and advisory practices, the Report finds that little attention was devoted by the Exchange to selling practices and supervision by its member firms of their branch offices despite disturbing evidence that abuses were occurring. It also finds that, at least until recently, the Exchange's concern with advisory material has been focused more on questions of good taste than on the qualifications and standards of its member firms' research departments. The Report also points to the absence of Exchange efforts to regulate odd-lot trading as a different kind of illustration of its failure to exercise regulatory initiative.

Noting that the surveillance techniques employed by the Exchange differ widely, the Study finds that the visitation program of Exchange examiners is an excellent fact-finding mechanism, particularly with respect to net capital enforcement and other matters where books and records are themselves revealing, while the Exchange's surveillance of market letters and selling activities and its members' supervision in these areas are found to be "minimal." The Report notes that only recently has the Exchange begun to pay close attention to branch office conduct.

The Study describes the Exchange's stock watching procedure as a "pioneering effort" in utilizing automation to detect market irregularities, but comments that the Exchange has not been as resourceful in adapting automation to the surveillance of member conduct on the floor and recommends that more significant and sensitive surveillance techniques applicable to floor conduct should be developed.

The Study concludes that the Exchanges's efforts in regulating specialists "have been intensive and systematic within the limits of its own concepts, yet they have been inadequate in total effect." The Report mentions the failure to focus adequately on concrete problems such as the applicability of the specialist's conflicts of interest in specific instances and disparate performances among specialists. While surveillance of floor traders relies principally on a reporting system, inaccuracies in floor trading reports have gone undetected, late filings have been tolerated, and repeated violations have been disposed of without disciplinary sanction.

The Report, in concluding that the Exchange's handling of public complaints involving its member firms is a significant limitation in its self-regulatory functioning, observes that complaints of serious impact have gone uninvestigated while the Exchange has performed essentially a buffering function. The Study recommends that the Exchange's handling of such complaints be re-oriented and that, in cases of this kind, the Exchange should act in a self-regulatory role and not in a protective role toward its members. Recent Exchange moves in this direction are noted by the Report.

The Report states that the Exchange's arbitration machinery appears to operate efficiently and fairly and that geographic expansion to make it more conveniently available to customers throughout the country would seem desirable. The Study recommends that arbitration should not be used as a substitute for or in derogation of the Exchange's exercise of its disciplinary responsibilities.

In the disciplinary area the Study concludes that the Exchange "leans toward tenderness rather than severity, but with some unevenness in respect of different types of violations." According to the Report, the Exchange appears more willing to impose severe disciplinary sanctions where the interests of its membership are directly at stake than where violations involve ethical standards in dealing with customers. Noting that admonitions and censures ("severe" or otherwise) are often the extent of punishment meted out, even for substantial infractions, the Study concludes that for self-regulation to be effective the Exchange should impose punishments that fit the infractions involved, particularly those involving ethical standards in dealing with the public. The Study also notes the high degree of informality and privacy surrounding Exchange disciplinary proceedings. It observes that the Supreme Court, in the recent case of Silver v. New York Stock Exchange, emphasized the crucial significance of fair procedures in self-regulatory actions affecting nonmembers, and concludes that "it would seem that similar considerations might broadly apply to cases affecting registered representatives, applicants for membership and members." The Report recommends that "there should be enough formality in disciplinary matters to provide basic fairness and also to assure adequate accountability at all levels of the self-regulatory process."

The Exchange's policy of not disclosing the names of individuals involved in its disciplinary actions, unless a member is suspended or expelled, may be assumed, according to the Study, to be attributable at least in part to a natural reluctance to publish anything adverse about any of its members. The Report notes that publicity about a sanction may itself constitute an additional sanction, but concludes that these considerations must be balanced against the public's interest in the conduct or misconduct of firms or persons with whom it deals and in the integrity of a public market place. The Study recommends that as a general principle, with such general or specific exceptions as the Commission may approve, disciplinary matters resulting in the imposition of a penalty by the Advisory Committee or the Board of Governors should be publicly reported. The Report also recommends that staff-imposed sanctions be periodically reported to the Commission.

The Report observes that the Exchange's interest in public relations is in the background of many of its self-regulatory activities. It notes that basically three elements are involved, promotion of share ownership by an ever-larger segment of the public, informing potential investors about securities and securities markets and counselling them about good investment practices, and advertising the quality of the Exchange's market and its member firms. The Report concludes that the more the Exchange does to encourage share ownership by "little" investors, who tend to be new and unsophisticated investors, the greater its obligation to provide rules and practices that are actually in accord with the needs of such investors, and the greater also its obligation to avoid exaggerations and misunderstandings of what the actualities are. The Report comments that "[w]hile it would be unfair to suggest that the Exchange has been unmindful of its substantive obligations to the people it invites to deal with its member firms in its market, in recent years it appears to have been disproportionately concerned with the image of itself and its members that it projects." The Study points out that even if the Exchange's publicity were always justified by the facts, "it may be open to question whether advertising the quality of its market and member firms is wholly compatible with the Exchange's statutory role as self-regulator." In its role as self-regulator, states the Report, the Exchange stands in the shoes of the government itself, and must have an appropriate degree of aloofness from those it is regulating. It concludes that the "effectiveness of self-regulation is certain to be dulled where the same individuals who are responsible for policing an organization and elevating its practices and standards are simultaneously concerned with advertising how good it already is." While the Study recommends that the Exchange's public relations efforts directed toward informing potential investors about securities markets and counselling them about good investment practices should be continued or even increased, as should its publication of significant economic and statistical data, it also indicates that public relations efforts directed toward emphasizing the merits of the Exchange's mechanisms or members are not wholly compatible with the Exchange's self-regulatory role and should be left to individual members or their unofficial organizations.

The American Stock Exchange

In a brief evaluation of the American Stock Exchange ("Amex") as a self-regulatory institution, the Special Study summarizes its staff report on the organization, management, and regulation of the conduct of members of the Amex (Securities Exchange Act of 1934 Release No. 6699, Jan. 6, 1962), and discusses major steps taken by the Exchange to correct deficiencies and abuses which were found on the Exchange. The 1962 staff report had concluded: "There can be little doubt that in the case of the American Stock Exchange the statutory scheme of self-regulation in the public interest has not worked out in the manner originally envisioned by Congress. The manifold and prolonged abuses by specialists and floor traders and other instances of misconduct described in this report make it clear that the problem goes beyond isolated violations and amounts to a general deficiency of standards and a fundamental failure of controls."

According to the Report one of the most important changes involved material revision of the Exchange's governing instruments, including the adoption of a new constitution patterned largely after the constitution of the New York Stock Exchange. Under the new constitution, the Report notes: The Board of Governors has been made the sole policy-making body; the standing committee system criticized in the January 1962 report and in the report of the Levy Committee, an industry group which studied the Amex, has been eliminated; the paid staff has been given added authority and a more important role in administering Exchange affairs; and the new constitution has changed the method of selecting members of the Board of Governors to prevent recurrence of specialist domination of the Board and to give Board representation to members located outside the New York City metropolitan area. The Report also lists important administrative changes effected by the Exchange and notes that in September 1962 a new President with greatly expanded powers and duties and a new Board of Governors assumed management of the Exchange.

The Exchange, the Report comments, has devoted considerable effort to tightening its listing and specialist regulations, and observes that the Exchange's former flexible listing standards have been replaced by more specific ones and that delisting criteria have been adopted. In addition, according to the Report, listed companies are now required to solicit proxies for all meetings of shareholders and to publish quarterly earnings reports. Among the new specialist regulations adopted by the Exchange and cited by the Report is the requirement that specialists report to the Exchange transactions with public customers, while another regulation recently adopted establishes increased minimum capital requirements under which specialists must maintain a cash or liquid asset position of at least $50,000 or an amount sufficient to assume a position of ten trading units in each security, whichever is greater.

In discussing the disciplinary actions taken by the Exchange against those whose activities were criticized in the January 1962 report, the Report notes that the Exchange suspended James Patrick Gilligan and Albert Will for periods of three years and one year, respectively, and fined them $5,000 and $2,500, respectively, for conduct found to be inconsistent with just and equitable principles of trade and for violations of the Exchange Act. These individuals were partners in the specialist firm of Gilligan, Will & Co., whose operations were dealt with at length in the staff's January 1962 report. The Special Study also points out that the Exchange disciplined four floor traders who, according to the January 1962 report, apparently violated the Exchange's floor trading reporting requirements and/or its floor trading rules. Three of these individuals, the Report observes, were suspended from the Exchange and fined.

In its overall evaluation of the recent reforms instituted by the Exchange, the Report concludes: In contrast to the prior breakdown of self-regulation described in the staff report (of January 1962) these reforms appear to be excellent demonstration of the effectiveness of self-regulation under responsible Exchange leadership and active Commission oversight.

Midwest Stock Exchange

The Study states that the Midwest Stock Exchange ("MSE"), located in Chicago, is one of the largest regional exchanges and occupies an important position in the securities markets with a potential for an expanded role in future years. The MSE is the result of a consolidation in 1949 of the former Chicago Stock Exchange and exchanges located in Cleveland, St. Louis, and Minneapolis-St. Paul.

The Report describes the Exchange staff as playing a "crucial role" in the administration of the MSE and in regulating member conduct. According to the Study, the experience of the MSE highlights the importance of a paid staff with sufficient authority and responsibility to accomplish effective self-regulation. The Study observes that the key position of the president of the MSE in the Exchange's disciplinary machinery and administration contributes to the efficient performance of the Exchange as a self-regulatory agency. According to the Study, the MSE president has greater authority in some respects in disciplinary matters than the presidents of other exchanges.

The government of the MSE, as described by the Study, is vested in a Board of Governors with representatives from each of the cities whose exchanges were merged into the MSE. The Report notes that MSE has six public "advisors," nonmembers who represent the public at meetings of the Board, but these advisors rarely attend Board meetings and their impact on the affairs of the MSE appears to be minimal.

In assessing the Exchange's performance as a self-regulatory institution, the Study states that the MSE has taken leadership in a number of significant ways, including qualification examinations for members. The Study observes that the MSE's self-regulatory program devotes considerable effort to the enforcement of its net capital rule but seemingly inadequate attention to member firm selling practices. The Study notes that the MSE's regulatory efforts are directed principally toward sole members and securities traded only on that Exchange. The MSE does not examine firms that are also members of the NYSE. The Report points out that, as of May 1962, 121 of the 306 member organizations of the MSE were also members of the NYSE.

Noting that certain recommendations of the Study applicable to other exchanges may also apply to the MSE, the Study recommends that Commission and Exchange representatives undertake to determine the possible applicability of such recommendations, and the Exchange should proceed to implement such recommendations or adaptations as may be found appropriate.

Pacific Coast Stock Exchange

The Pacific Coast Stock Exchange ("PCSE"),according to the Report, is important as a securities market because of its present business--it had the largest volume of shares traded on any regional stock exchange in 1962--and because of its potential for future growth.

Formed as a result of a consolidation in 1957 of the Los Angeles and San Francisco Stock Exchanges, the PCSE has two separate divisions, each with its own trading floor and each connected to the other by an elaborate communications system. The Study observes that considerable effort is expended in keeping the two divisions on an equal basis in the government of the Exchange, with each division retaining considerable autonomy in finances, administration and discipline. For example, each division is operated by a Division Management Committee and the principal office and the position of chairman of the Board of Governors of the PCSE rotate annually between San Francisco and Los Angeles.

The PCSE is unique among the largest exchanges in the degree to which its Board and committees participate directly in the operation and management of the Exchange. The Study points out that the Division Management Committees and the standing committees of the PCSE exercise important regulatory and administrative responsibilities, with the paid staff occupying a less important position in the regulatory structure than in the case of the New York, American or Midwest Stock Exchanges. Noting that "experience has demonstrated that in an exchange of substantial size this kind of arrangement is of less than maximum effectiveness and has within it the potential for abuse," the Report recommends that the PCSE, under the supervision of the Commission, undertake a thorough examination of its organization with a view to providing a paid staff of adequate size and authority in regulatory matters in lieu of its present reliance on the committee system.

The Study points out that the Board may not act on a matter that "solely concerns the internal affairs or assets" of a division and that a member may appeal an expulsion to the membership. In order to insure that the Board of Governors has adequate authority to administer the affairs of the PCSE, the Report recommends that consideration be given to the elimination of those provisions in the constitution of the PCSE which may unduly restrict the Board in the exercise of its authority.

According to the Report, the PCSE in its regulation of member firm conduct emphasizes enforcement of its net capital rule, particularly with respect to firms which are not members of any other major exchange. The Report concludes that members' selling and advisory activities receive inadequate attention and the Exchange's handling of public complaints should be strengthened.

The Study notes that certain recommendations applicable to other exchanges may also apply to the PCSE. The Report recommends that Commission and Exchange representatives undertake to determine the possible applicability of such other recommendations and that the Exchange proceed to implement such recommendations or adaptations as may be found appropriate.

The Other Exchanges

The Special Study notes that in addition to the New York Stock Exchange, American Stock Exchange, Midwest Stock Exchange, and Pacific Coast Stock Exchange, discussed in previous parts of Chapter XII, there are ten other exchanges registered with the Commission. These are: Chicago Board of Trade, Boston Stock Exchange, Cincinnati Stock Exchange, Detroit Stock Exchange, National Stock Exchange, Philadelphia-Baltimore-Washington Stock Exchange, Pittsburgh Stock Exchange, Salt Lake Stock Exchange, San Francisco Mining Exchange, and Spokane Stock Exchange. According to the Study, these ten exchanges account for only two percent of the dollar volume and three percent of the share volume of securities traded on all exchanges.

The Study's inquiry with respect to the exchanges other than the NYSE, Amex, MSE, and PCSE was generally confined to a review of their constitutions and rules. Because no study was made of the surveillance and disciplinary procedures of these exchanges, the Report draws no conclusions as to the effectiveness of their regulatory activities.

The Study finds that despite wide differences among the ten exchanges, certain organizational similarities exist. Operation of these exchanges is generally vested in a governing committee and in standing committees with authority in specified substantive areas. The Report observes that the role of the paid staff is relatively minor and, except for the largest of these exchanges, the staffs are quite small.

The Report states that on numerous occasions since the passage of the Exchange Act the need of registered exchanges for qualified staff personnel with sufficient authority has been demonstrated. The Study concludes that, to the extent this is not economically feasible for some of the smaller exchanges, there is a corresponding limit on what may be expected of self-regulation, and the Commission's direct regulatory activity must be adopted accordingly.

The Report refers to the recommendations pertaining to the organization and regulatory performance of the New York Stock Exchange and the other exchanges set forth in other parts of the Report. It states that it was not possible to indicate the applicability of each recommendation to each registered securities exchange, nor has it been possible to analyze the special circumstances of each exchange to determine in what respects changes are desirable. "Consequently," the Report concludes, "on the basis of an assessment of the applicability of the recommendations to the particular exchange, each exchange should make such changes in its rules, practices, and procedures as may be appropriate."

National Association of Securities Dealers, Inc.

In its report on the National Association of Securities Dealers, Inc. (the "NASD" or the "Association"), the Special Study calls for a basic modification and strengthening of the Association's organization if it is to fulfill its role as the principle self-regulatory agency for non-exchange members. The Study states that in spite of its record of accomplishment and expansion, the NASD now appears to be "at a cross-roads."

The Study observes that the NASD's regulatory task is a peculiarly difficult one, involving as it does a unique combination of several factors. The Association's membership is very large and not pre-selected--it is compelled to open its doors to all qualified persons and the qualifications have not been particularly selective. Its membership has come to be nationwide, and it includes virtually all broker-dealers engaged in a general securities business--broker-dealers representing wide diversities in financial resources, standards and activities. In 1939, the NASD commenced operations with a membership of 1,500 firms out of a total of about 6,700 broker-dealers registered with the Commission, or 22 percent of all registered firms. By December 31, 1962, Association membership had grown to 4,771, or 83 percent of 5,724 registered firms. When the Association began its registered representative program in 1945, it covered about 25,000 individuals. By December 31, 1962, that figure had reached 94,444, encompassing the vast majority of securities salesmen.

The Report states that the scope of the NASD's responsibility is very broad, and at the same time it has primary responsibility in the vast but relatively uncharted over-the-counter markets. Unlike the exchanges, the Association did not exist prior to the adoption of the Exchange Act; the NASD was specifically organized under a statute enacted in 1938 to establish co-operative regulation between industry and government in the over-the-counter markets. Except insofar as it supervises the dissemination of retail quotations and sponsors stock clearing arrangements, the NASD is not directly engaged in the operation of a marketplace and its members are not "seat" holders with a proprietary interest in a marketplace.

The Special Study notes that the NASD is organized to obtain a large degree of local administration of its affairs. There are 13 districts throughout the country responsible for providing representatives to the 21-member national Board of Governors in whose control the overall management and supervision of the Association rests. The Board oversees a paid staff of some 160 headed by an executive director. There are both standing and special committees, some of which are composed of non-board members and some of which have their own administrative staffs.

The Report states that the Association has adopted rules of fair practice, enforced by the local districts, governing the professional conduct of members in their securities business. Each local district is managed by a district committee composed of from 6 to 18 members and a paid staff headed by a district secretary. These committees double as district business conduct committees and as such initiate charges against rule violators, hear and determine such charges, and assess penalties which may range from censure or fine to suspension or expulsion from membership. District business conduct decisions are reviewable by the Board of Governors, with Commission and ultimate court review also available.

The Special Study states that the NASD has emerged 24 years after its founding as "an established part of the regulatory scheme exerting a substantial influence on numerous phases of the securities industry." While noting that the Report is in many respects critical of Association performance, the Study finds that the NASD has many important accomplishments to its credit and that "its history evidences a clear desire to expand the role of self-regulation in the total regulatory scheme and to make self-regulation work." The Report notes that some of the problems of self-regulation experienced by the NASD, such as delays in disciplinary proceedings, backlogs in investigations, and inadequate staff, have their counterparts in the Commission's performance of its total role which may be seen at various places in the Report.

The Report refers to the fact that over the years NASD standards of conduct have multiplied and now deal with many aspects of the securities business. In enforcing those standards, the Association now makes over 1,700 special and routine examinations (i.e., inspections) of its members annually and institutes more than 450 formal disciplinary proceedings in a year. It also engages in various other activities of a regulatory nature, such as the administration of a qualification examination for salesmen and review of underwriters' compensation and mutual fund selling literature. The Report notes that the NASD has been active in raising standards for qualifications for entry into the securities business and recently has strongly endorsed the Commission's legislative proposals in this area.

Although the NASD has made many important advances in its relatively brief history, the Study finds that the NASD has fallen short of its potential as a self-regulatory body. It points to the many areas described in the Report that have proved in need of regulation, and particularly suited to self-regulation, that have been neglected by the NASD. According to the Report, the causes seem to lie in the NASD's fundamental organizational concepts and arrangements. From the beginning, the Study finds, the NASD has sought to adhere to a concept of self-regulation with maximum emphasis on "self"--members in the securities business regulating themselves--and with minimum reliance on a full-time staff. This concept is found to apply in every aspect of the Association's work, not merely in areas of policy but also, and most pointedly, in the area of complaints and disciplinary actions against members. At all levels, although staff assistance is used, hearing and decision is by members, i.e., part-time volunteers serving this and other needs of the organization. At the district level, this has produced "severe strains, delays and compromises." At the national level, the Study states, reliance upon part-time volunteer members threatens a breakdown in the capacity of the organization to act promptly and--an even more serious problem--its capacity to deal adequately with important questions of policy and program. There is now, according to the Study, such preoccupation with disciplinary matters in addition to matters of internal administration that little time is left for top governing officials to perceive and solve larger questions.

The Study points out that the term of a national governor is three years, with a one-third turnover in the membership every year. Since the Board ordinarily meets only three times a year for three days at a time, the Report observes, there are limitations of time and continuity on the Board's ability to perform its job. Despite the increase in the workload the Board, according to the Study, has been reluctant to reduce its responsibility for enforcement; in fact, control over enforcement, particularly through review of disciplinary cases, has been its dominant activity at the expense of its role of policy formulation. The Study states that despite the efforts which the Board has made to cope with the increased volume of disciplinary matters (in 1962 the Board considered 115 disciplinary cases), there seems little likelihood of success without a change in prevailing practices.

The Study states that the factor of time has another aspect. It points out that small member firms ordinarily cannot afford to allow their principals to take major roles in NASD affairs. This limitation is reflected in the composition of district and national committees and the Board of Governors--a majority of members of the Board and district committees are from large NYSE firms. Partly for the same reason, the Report observes, the Association also has had only limited success in conforming to its objective of obtaining "appropriate and fair" representation of various important classes and types of member firms.

According to the Report, "the essentially unsolved--and gradually worsening--problem of the NASD is to find a mode of functioning effectively while not unduly sacrificing its emphasis on the 'self' in self-regulation." The solution of this problem, the Study believes, will require substantial rethinking as to (1) the composition and role of the full-time staff in relation to the role of the volunteer officials and also as to (2) the allocation of responsibilities among volunteer member participants.

The Report states that "the time has come, if it has not been long overdue, for the NASD to have an executive staff of adequate numbers and with adequate delegation of responsibilities." Only in this way, according to the Report, can there be found any real hope for carrying the workload, in view of the inherent limitations on the time that can be devoted by members actually engaged in business. Moreover, it states, only in this way is there any chance of assuring the continuity of program and administration that cannot be achieved by volunteer part-time officials elected in one-year or three-year cycles. The Special Study states that the creation of a larger staff with larger responsibilities should not weaken the fabric of self-regulation but should serve to strengthen it--obviously such a staff would work under the Board of Governors, not above it or apart from it. The Study recommends that the office of Executive Director, the NASD's chief staff post, be upgraded to that of president; that he be made a voting member of the board and some or all of its standing committees; that with adequate assistance of vice-presidents and department heads he should have responsibility for continuous administration by the entire staff; and that consideration be given to granting him tenure for a limited period of years.

The Study concludes that the staff should have a larger role in all enforcement and disciplinary activities until the stage of actual decision of individual cases and that it be equipped, available, and utilized to conduct studies or otherwise assist elected officials and member committees in formulating policies and programs of self-regulation on a continuing basis.

With respect to the allocation of work among member participants in the government of the Association, the Report states that several possibilities should have early and serious consideration to enable the Board of Governors to concentrate on larger problems and programs. It recommends that the National Business Conduct Committee, under appropriate liaison with the Board of Governors, be given final power of decision in disciplinary matters, except where the Board in its discretion "takes jurisdiction" because of the novelty or importance of particular cases or questions. Apart from disciplinary matters, the Report states, important topics and programs requiring more concentrated attention than the Board itself can give should be the province of permanent or ad hoc member committees under appropriate liaison with the Board. Such committees should act as arms of the full Board and subject to its overall direction and coordination with staff assistance as needed by each committee. However, the Study points out that staff assistants to committees should be under the overall direction of the heads of staff so as to assure efficient integration of separate areas of interest into the total self-regulatory effort. It is further recommended that an Executive Committee that can be expected to meet more frequently than the full Board of Governors be given increased authority to act on its behalf in intervals between Board meetings.

The Special Study recommends that the Association give prompt consideration to ways and means of obtaining a better distribution of seats on district committees and the Board of Governors by classes and types of firms. Among the possibilities as to Board representation which the Special Study suggests might be explored is an amendment to the Association's by-laws permitting election or appointment of a limited number of governors-at-large in instances where the present scheme of selection results in lack of size or functional representation for a particular class of firms. At the district level, the Report observes, existing by-law provisions appear to be sufficiently flexible to achieve these objectives to a greater degree than is now the case.

The Study finds the NASD's modes of surveillance of members' conduct quite limited even in relation to the present scope of its self-regulatory concern, and there is considerable diversity in methods and extent of surveillance as among districts. The Association, the Report states, has placed comparatively heavy reliance on the examination program in its surveillance of member conduct. This reliance is found to have yielded significant results in uncovering rule violations ascertainable through inspection of books and records but has left much to be desired in other spheres. The Study states that the Association experience with other methods of surveillance, such as those employed in its programs for review of mutual fund sales literature, underwriters' compensation, and suspected free-riding, suggests that still other possibilities for supplementing or augmenting the examination program may exist. In any event, the Special Study concludes, the examination program itself seems to require a large degree of bolstering. It observes that the Association's frequency goals are relatively modest; but even with limitations on follow-up procedures apparently caused, at least in part, by the pressure to keep on schedule, these goals have not been met, notably those for branch offices and newly-admitted members.

The Study finds that disciplinary procedures, protected by statutory prescriptions and provisions for Commission review, have been generally fair. However, the Report notes that a lack of clear definition of some of the Association's broad standards of conduct, restricted publication of decisions, the regional emphasis that has been characteristic of its self-regulatory approach, and disparity in the penalties assessed against violators in particular instances, have resulted in some unevenness and possible inequity in disciplinary results. The Study finds that the principal problem, needing corrective action in proportion to its seriousness, has been with respect to efficiency and speed in handling disciplinary cases. Procedural improvements suggested by the Report are: the use of full-time hearing officers and delegation of increased authority to staff members to review inspection reports, investigate complaints, make recommendations to District Business Conduct Committees for formal complaint proceedings, and, in the case of the staff of the national office, file formal complaints. The Study recommends that, as a general principle, NASD disciplinary matters resulting in penalties, with such specific or general exceptions as the Commission may approve, should be publicly reported.

The Report states that the NASD has historically operated on a somewhat limited budget in relation to its responsibilities. It points out that implementation of the recommendations of the Report would undoubtedly tend in the direction of additional operating costs, although presumably capable of being at least partially offset by adoption of the recommendations calling for the upgrading of standards for entry into the business and better coordination and elimination of duplication among agencies. Still, the Study says there is reason to believe that the financial burden on the general membership of the Association need not be materially increased if there is greater resort to some classes of members who may not now bear their fair share of the costs. For example, the fee structure provides for a special charge measured by underwriting activities but not for trading activities. Thus, it was found that the 67 largest over-the-counter firms, each of whom had more than $100,000,000 in over-the-counter sales in 1961 and accounted for 54 percent of all such business in that year, paid only 16 percent of the total assessments collected by the NASD in fiscal 1961. In addition, the maximum assessment limits applicable to all firms may have unduly limited the Association's revenues from some of the largest firms. The Special Study recommends that the NASD pursue studies looking to early revision of its fee structure in relation to the business of its members and its own budgetary requirements.

The Report concludes that the greatest lack in the NASD's performance as a self-regulatory body is its failure to address itself to various important problems in the over-the-counter markets. Many of its major achievements have represented, according to the Study, not a taking of initiative to grapple with a problem but rather a defensive response to a pending proposal or imminent action of the Commission. The Study points to the areas described in this report where the NASD either has not acted or has taken what must be considered inadequate action in dealing with problems that would seem to call for greater attention. However, the Study's discussion of limitations in the NASD's performance is not intended to overshadow or disparage the record of accomplishment but to point to an even stronger future role.

Quasi-Self-Regulatory Institutions

The Special Study also analyzes the roles of several "nonofficial" organizations which exist in the securities business and which fall within a category styled by the Report as "quasi-self-regulatory organizations."

The Investment Bankers Association (IBA), the first of the organizations discussed, is described as the oldest and perhaps best known of the nonstatutory organizations. According to the Report it is essentially an association of underwriters, although its membership of some 792 firms also includes general broker-dealers, stock exchange specialists, sponsors of mutual funds, and some commercial banks. To become a member of this organization, notes the Report, a firm in any one of these groups must meet strict financial and other standards. The Report states that the IBA performs no self-regulatory functions as such but does devote attention to industry educational projects. These include the conduct of an annual institute of investment banking at the Wharton School of Finance and Commerce, University of Pennsylvania, and the conduct of a continuing research and study effort by a regularly paid staff.

In a description of the Association of Stock Exchange Firms (ASEF), an organization of 518 New York Stock Exchange firms, the Report observes that this organization also devotes its major efforts to educational functions, particularly in connection with securities subjects of a technical nature. The ASEF in conjunction with its six operating divisions covering accounting, cashiers, credit, dividend, purchases and sales,and senior order clerks, publishes pamphlets and other materials on the subjects of credit, gifts of securities or money to minors, NYSE minimum commission rates, and preservation and destruction of records, etc. The Report concludes its analysis of the ASEF with the observation that the Association performs needed functions and offers important services to the exchange community.

The Investment Company Institute (ICI) and the Association of Mutual Fund Plan Sponsors (AMFPS) are the two organizations in the mutual fund field which the Report discusses. The ICI has three classes of members: investment companies, investment advisors, and investment company underwriters; and, according to the Study, the total assets of its investment company members represent 94 percent of the assets of all registered open-end investment companies. The Report observes that one of the purposes of the ICI is to encourage among its members adherence to high ethical standards. In furtherance of this objective it has adopted a guide to business standards which suggests, among other things, that investment company officials and employees should refrain from private dealings in securities which they know their company has determined to purchase or sell for its portfolio or where they know such action to be under immediate consideration; discourages release of information about portfolio changes that have been or are in process; opposes the purchase of securities by investment companies shortly before ex-dividend dates primarily for the purpose of obtaining the immediate dividend; encourages the conduct of portfolio transactions in a responsible way in pursuance of member companies' stated investment objectives and subject to restrictions relating to reciprocal business; discourages "special deals" to selling group members; and establishes standards relating to the announcement of income and capital gains distributions. The Report, however, makes it clear that the ICI imposes no sanctions for violation of any of these principles or standards.

The second of the mutual fund organizations discussed, the AMFPS, restricts membership to firms sponsoring contractual plans. The Study states that its 22 members accounted for approximately 66 percent of the aggregate amount of contractual plans sold as of December 31, 1962. Although its purposes do not include the formulation and enforcement of standards of business ethics, the Association has adopted a code of business conduct covering general business, competitive, investment management and dealer practices; but, like the ICI, the AFMPS has no machinery to enforce the provisions of its code.

Another industry organization discussed in the Report is the Investment Counsel Association of America (ICAA), which limits its membership to those firms engaged primarily in giving continuous advice as to the investment of funds of their clients on the basis of the individual needs of each client exclusively on a fee basis. The ICAA has adopted a general statement of functions and principles but has no detailed code of ethics or business standards for its members. According to the Study the organization's main efforts have been devoted to achieving public recognition of the specialized and assertedly professional nature of the services of its members, and although its bylaws give its board of governors power to discipline members, the ICAA does not, in fact, presently conceive of itself as a self-regulatory body.

The Association of Real Estate Syndicators (ARES), another industry body described by the Study, operates in the relatively new field of real estate securities. Its 64 members are largely located in the New York City area where the distribution of such securities in the past few years has been concentrated. The Association's governing instruments provide for certain self-regulatory functions and include machinery for the review and clearance of literature used in selling real estate securities. The Report notes, however, that since the State of New York adopted its real estate syndication law in 1960 the Association no longer continues this review and clearance activity.

The Put and Call Broker and Dealer Association is described by the Study as "the most highly organized of all the nonofficial self-regulatory organizations." Although small in number the Association includes among its members virtually all brokers and dealers which handle puts and calls. After quoting pertinent sections of a report on puts and calls issued by the Commission's Division of Trading and Exchanges in October 1961, the Report observes that the Association has assumed firm control of its members and the put and call industry in general, perhaps as great a degree of control as that which certain official self-regulatory bodies have over their members and their members' activities.

Another organization mentioned by the Report is the National Association of Investors' Brokers whose two functioning member organizations are located in New York (Association of Customers' Brokers) and in Chicago (Stock Brokers' Associates of Chicago). Both of these organizations limit their membership to qualified nonpartner registered representatives of firms affiliated with certain stock exchanges. Both groups have as a basic purpose the preservation of the "high standards of the securities profession" but, according to the Report, the actual regulatory significance of the Association and its two-member organizations is minimal.

The National Security Traders Association, Inc. (NSTA), with a membership of some 5,000 individuals, is described by the Report as an organization which until "only recently was primarily a social organization designed to permit over-the-counter traders to become personally acquainted with other traders with whom they dealt over the telephone." In recent years, however, NSTA has expanded the scope of its activities to include the sponsorship of certain educational programs. The Association has also recently indicated some interest in acting as a spokesman for individual traders in matters of concern to the securities industry but it has never assumed any self-regulatory functions.

In summing up this Part, the Report observes that these nonofficial organizations cannot be considered as providing a satisfactory source of self-regulation or substitute for regulation in areas where regulation is deemed necessary in the public interest. Accordingly, the Report concludes that "ideally, official self-regulation should be extended to include all elements of the securities business that feasibly can be included."

Self-Regulation and the Commission

In a part of Chapter XII devoted to the role of the Commission in relation to self-regulation, the Special Study summarizes some of the considerations of theory and policy underlying the broad concept of self-regulation, reviews the actual functioning of the regulatory patterns in relation to the Commission, the exchanges and the NASD, and appraises the adequacy of the existing system. The Special Study recommends that regulation in the field of securities should continue to be based on the principle of giving maximum scope to self-regulation, wherever and to the extent that a regulatory need can be satisfactorily met through self-regulation. "As a corollary," states the Study, "it is an essential role of government, i.e., the Commission, to assure that there is no gap between the total regulatory need and the quantity and quality of self-regulation provided by recognized agencies."

In its discussion of the theory of self-regulation the Study notes that since self-regulatory organizations possess governmental power in important respects, the Commission has a crucial function of public oversight. This function is necessary in order to insure that the delegated powers are exercised effectively and also not in a manner inimical to the public interest. Another important area of governmental oversight, according to the Report, involves those aspects of self-regulatory agencies' activities which resemble those of public utilities, such as the NASD's operation of a retail quotation system, programs for automation of market mechanisms, and the setting of uniform commission rates by exchanges. The Report cautions, on the other hand, that the workability of self regulation depends on restraint in the Commission's exercise of its reserve power and notes that the roles of the Commission and the self-regulatory agencies are essentially complementary, and that the self-regulatory agencies must enjoy such autonomy as will enable them to act as responsible, dynamic partners in a cooperative enterprise.

The Report refers to the recent Supreme Court decision in the case of Silver v. New York Stock Exchange, where the Exchange was held liable under the anti-trust laws to a nonmember broker-dealer for causing Exchange members to discontinue their wire connections with him. Because of the absence of a review power in the Commission to insure that an exchange's enforcement of its rules is not arbitrary and does not injure competition without "furthering legitimate self-regulative ends" the Court thought it proper for antitrust courts to perform this function. The opinion expressly left open the question of application of the antitrust laws in those areas where the Commission has a review power over self-regulatory actions, such as with disciplinary proceedings of the NASD.

According to the Report, the statutory provisions of the Exchange Act establishing the relations between the Commission and the stock exchanges on the one hand, and between the Commission and the NASD on the other hand, are broadly similar, but marked differences are also noted which are attributable to differences in the natures and historical backgrounds of the two types of organizations and to the fact that there was a time interval of several years between the enactment of the two sets of provisions. The Study concludes that a reexamination of these differences and of related Commission responsibilities is now warranted in light of subsequent experiences and developments, including the Silver decision.

With reference to the Commission's role of oversight toward the exchanges, the Study states that the most pressing question today, as emphasized by the Silver case, concerns exchange enforcement and disciplinary matters. The Report concludes that minimum requirements of "due process" should be applicable to disciplinary proceedings of exchanges that may result in denial of membership or employment or imposition of fines, suspensions, or expulsions of members or employees, or that may affect the right of specific nonmembers to do business with members. If self-regulation is to function effectively and with due regard for all aspects of the public interest, notes the Study, the necessary review of self-regulatory action should be performed by the Commission, the agency already established as the guardian of the public interest in the securities industry.

In the absence of provisions for formal Commission review, observes the Report, the exchanges have followed varied practices in reporting their disciplinary actions to the Commission, which has not established an effective system of regular surveillance of the exchanges' enforcement and disciplinary activities. Similarly, according to the Study, the Commission has no program for broadly or systematically surveying the operations of the NASD disciplinary system from the point of view of its total effectiveness or its conformity with statutory objectives. To prevent recurrence of the kind of self-regulatory breakdown that took place on the Amex in recent years, the Special Study recommends that the Commission must reexamine and strengthen its total concept and program for surveillance and oversight of self-regulatory discipline. In general, the Study concludes that the strengthening of the Commission's program should include more direct and continuous awareness of actual happenings in the market place, stronger and more continuous liaison with each exchange and the NASD as to its self-regulatory problems, and fuller and more systematic accounting by the exchanges and the NASD as to their self-regulatory progress and results.

In discussing the Commission's role with respect to the rules of the self-regulatory agencies, the Study points out that the Exchange Act does not expressly require exchanges to file rule changes prior to adoption, but NASD rule changes are required to be filed in advance and may be disapproved by the Commission before effectiveness. In 1956, according to the Report, the NYSE agreed to give the Commission notice of material changes at least two weeks before public announcement, except in unusual circumstances, and for the past year both the NYSE and the Amex have followed the practice of discussing proposed rule changes with the Commission staff prior to submitting them to their respective boards of governors. It is noted that the regional exchanges generally do not discuss rule changes in advance but merely file them after adoption pursuant to the statute. The Special Study concludes that an obviously needed change is to provide for the filing of all proposed rule changes by exchanges with an adequate interval before effectiveness, as is now required in the case of NASD rules. Furthermore, states the Report, the Commission has no program for regular or systematic review of existing rules or policies of the self-regulatory agencies and the present arrangements and procedures for review do not seem sufficient to assure the needed continuous oversight on the Commission's part.

According to the Report, the Commission's total role under the Securities Act of 1933 and the Securities Exchange Act of 1934 may be broadly divided into two main categories: (1) administering disclosure requirements for issuers and (2) regulating conduct in the securities markets, directly or by supervision of self-regulation. It appears to the Special Study that the Commission has been more successful in exercising its powers and responsibilities in the former area than in the latter. The Report notes that efforts have been very productively devoted to enforcement of the laws and regulations through administrative, injunctive, and criminal proceedings against violators, but it states that an insufficient portion of the attention and energies of the Commission and its staff in the post-war years have been devoted to other important responsibilities such as continuous examination of changing market circumstances and regulatory needs, appraisal and re-appraisal of the adequacy of the existing regulatory measures, and evaluation and oversight of the operation of the self-regulatory organizations. This role, concludes the Study, should be assumed primarily by the Commission's Division of Trading and Exchanges, which is one of the most important of its operating divisions and has been manned by persons of great competence and dedication, but which does not appear to the Study to have been adequately staffed or organized to fulfill its potential and necessary role in respect of the types of responsibilities mentioned.

In addition to placing stronger emphasis on its responsibilities in the area of regulation and supervision of self-regulation, the Special Study indicates that the Commission should publicly record the substantive results of its administration of regulatory and supervisory powers to a greater extent than has been its practice. Actions or policy determinations of importance, even though not reflected in formal decisions, should, according to the Report, be more regularly recorded for the information of the public and the Congress and for the guidance of the industry, the self-regulatory bodies, and future members of the Commission and its staff.

The Total Regulatory Burden--The Need For Increased Coordination--The Role of the States

The Special Study, in the last part of its chapter on the self-regulatory institutions and the regulatory pattern, discusses the need for increased coordination of the over-all regulatory effort and the regulatory role of the States. The Report points out that the subject of coordination is an important one since the securities community is subject to regulation by the various exchanges, the NASD, the States, and the Commission, and virtually all broker-dealers fall under the regulatory authority of more than one of these agencies. The Special Study observes that insofar as the regulatory work of these organizations overlaps, their members are saddled with added costs and burdens, and the personnel and resources of the agencies are not being utilized "to achieve maximum performance."

The Special Study, in examining the problems of duplication and lack of coordination in various regulatory areas, states that until recently each of the self-regulatory agencies administered its entry and qualification requirements with little regard for the standards of other bodies. The Report notes that the exchanges and the NASD frequently have different rules covering the same subjects, thereby increasing the complexity of regulation for the multiple member firm and raising the possibility that different standards will be applied to identical conduct.

In respect of inspection of broker-dealer firms, the Special Study finds a limited amount of coordination and points out that the NASD, the major exchanges, and the Commission pursue a policy under which no securities firm is to be inspected by more than one of these agencies in any six-month period unless special problems exist. The Report finds, however, that there have been no efforts to standardize inspection procedures, and it has only been recently that any attempt has been made to exchange information obtained through inspections of broker-dealer firms among the self-regulatory agencies.

In discussing enforcement and disciplinary matters the Report states that there has been little formal or informal communication among the self-regulatory bodies as to investigations which are contemplated, or in progress, and notes that even the results of disciplinary actions have not been made available to interested agencies. Without attempting to formulate a final answer the Study recognizes that a question of some perplexity and considerable importance arises in determining which of several agencies, or whether more than one, should bring a disciplinary proceeding for conduct in violation of the rules or standards of each of them. It does, however, say that stronger lines of communication between the different bodies are essential and that a greater effort must be made to clarify existing relationships.

The Report examines recent industry efforts to bring about better coordination and indicates that important steps have been taken by some of the agencies in connection with the handling of customer complaints, policing underwriters' compensation, enforcing regulation T, and establishing combined qualification examinations for securities salesmen. The Special Study welcomes these steps although it indicates that additional efforts are needed and recommends that "in the interest of the public, the regulatory agencies and the securities industry, further and continuing attention should be given to possibilities for coordinating efforts and allocating responsibilities in a more efficient and productive pattern, without limitation on any self-regulatory agency's freedom to have special measures or programs for its own membership." The Report lists such possibilities as "further standardization of application and report forms for firms and individuals to be used by all interested agencies with appropriate supplementation by each to serve its special needs; further development of centralized examining and investigating procedures, again with appropriate supplementation to meet special needs of each agency; coordination of efforts in defining standards of conduct in areas of common concern; clearer recognition of one agency or another as having primary enforcement responsibility in respect of particular categories of firms or subject matters; and stronger lines of communication among agencies to facilitate channeling of information relevant to the interests of each."

In discussing the role of the States in the regulatory pattern, the Special Study makes it clear that "there has not been and should not be Federal pre-emption in the field of securities regulation." The Report notes that State regulation operates in two ways. It provides a means of handling certain essentially local problems and also acts to supplement Federal regulation. The Report makes special mention of the important contributions of the states in establishing qualifications for broker-dealers and salesmen and in formulating standards in connection with the levels and kinds of compensation which underwriters of conventional and investment company securities may charge.

The Report also discusses the activities of the North American Securities Administrators, an association of state security officials from the United States, Canada and Mexico. It states that the work of this group has been useful in developing standards and policies in connection with such matters as reciprocal business practices of investment companies, and the acquisition of warrants and options by underwriters. This group, observes the Study, has also made progress in achieving greater uniformity of regulation among the states.

The Report briefly mentions the activities of the Midwest Securities Commissioners Association. As of April 1, 1962, this Association had representatives from 17 member states. The Report lists some of the accomplishments of this Association as the adoption of a uniform form of corporate resolution and a statement of policy which provides that variable annuity companies and trusts should generally comply with the rules and regulations applicable to investment companies.

The Report points out that the States clearly have a place in any broad-based program of regulatory cooperation, and that they have generally welcomed and participated in efforts along these lines. It finds, however, that the NASD is unwilling to furnish information to the States with respect to association disciplinary actions not otherwise made public and some state administrators have indicated that this attitude has impeded their enforcement programs. The NASD states that it has cooperated with the States in several important respects, but, since it is a membership corporation financed by its members, it is not free to make available to anyone but the Commission information it considers confidential. The Special Study, after weighing the respective positions, concludes that "on balance where investor interests must be protected, the nondisclosure policy of the NASD must give way to a more flexible one which would at the least permit (NASD officials) in their discretion to exchange information with the State securities administrators."

CHAPTER XIII

THE MARKET BREAK OF MAY 1962

In Chapter XIII of its Report, the Special Study of Securities Markets analyzes the severe price fluctuations (on heavy volume) which occurred on May 28, 29 and 31, 1962 (the "market break"). It concludes that the Commission and the industry should make a joint study of possible intermediate measures, short of suspending trading, that might be invoked to assure minimum disruption of the fair and orderly functioning of the securities markets in times of severe market stress. The Report states that once a break has passed there is a tendency to forget the concerns existing at the time and the apprehensions as to what might happen should it continue. It also suggests that there should be Commission-industry consultation with a view to collecting certain crucial types of trading information which might be helpful in connection with possible application of any of such intermediate measures.

Shortly after the market break, the Commission requested the Special Study to undertake an examination of the trading period and of who was buying and selling. Much of the analysis of the break appears in other chapters. For example: the conduct of specialists during the break, as well as the ramifications of short selling, are treated extensively in Chapter VI; the reaction of the over-the-counter market to the break is described in Chapter VII; and margin selling is dealt with in Chapter X. Many of the conclusions and recommendations expressed in those chapters, particularly Chapter VI, draw upon data gathered in the study of the market break.

In its analysis, the Special Study avoided duplication of the material contained in the New York Stock Exchange study of the market break, "The Stock Market Under Stress," issued in March, 1963. Although drawing on that study where appropriate, Chapter XIII presents new material in the form of a detailed analysis of trading in eight selected stocks. The Special Study examined trading on 16 nonbreak days in addition to the 3 days of the break, and also reviewed the general background of the events.

In its analysis of trading in the eight selected stocks the Study found that, while there were certain general patterns of behavior, there were also striking departures from the overall picture. On an aggregate basis, for example, individuals were reported by the NYSE to have sold stocks on May 28 and 29 and bought on May 31. Among the eight stocks studied, however, only General Motors duplicated this pattern. Also, while odd-lot customers in the aggregate sold stocks on May 28 they bought AT&T on balance that day. The open-end investment companies studied were altogether net buyers of stocks during the break, and especially in the preceding week, but they sold on balance stocks such as General Motors and U. S. Steel on May 28. They also persistently sold Brunswick and U. S. Steel from the fall of 1961 through June 1962. The Report points out that while on an aggregate basis the other institutions studied tended to accumulate stock before and during the break, they sold U. S. Steel from January through June 1962 and had heavy net sales in IBM from September 1961 through January 1962.

The Study found that among nonmembers of the NYSE, public individuals in the aggregate were usually the most important component in stock transactions; but in its analysis of particular stocks the Study found that on certain days individuals' purchases of Standard Oil (N.J.) were virtually matched in importance by the institutions. In addition, individuals' purchases of IBM were also equalled by the institutions and foreigners, the latter being usually a relatively small participant.

With respect to members of the NYSE (specialists, floor traders, odd-lot dealers, members off floor) the Study found the same story. In the aggregate, their transactions represented 20 to 24 percent of the total volume but on some days in each of the eight stocks they accounted for at least 35 percent of all purchases or sales on the NYSE, and in several of the stocks the percentage reached 50 percent or more on various days. As noted in Chapter VI, during the break the specialists on the NYSE had an overall purchase balance but were large net sellers of certain stocks, including Korvette, IBM and U. S. Steel. The detailed analysis of activity in the eight selected stocks, illustrated in the Report on a timed basis for May 28, reveals various instances where specialists were passive or were net sellers at critical junctures. These variations in the practices of the participants in individual issues reveal the inadequacy of aggregated data alone to portray realistically the members' and nonmembers' transactions in individual stocks.

The Report also states that the avalanche of orders during the break subjected the market mechanisms to extraordinary strain and in many respects they did not function in a normal way. Specifically, the late tape made it impossible for investors to predict accurately the prices at which market orders would be executed. In addition, the volume of odd-lot orders prevented some from being executed at the first round-lot sale following receipt, as required; instead they were executed at the day's closing price, which on May 28 was in most instances considerably lower. The Report also states that an unusually large volume of sell stop orders on May 28, which were converted into market orders as prices declined, created what one specialist in testimony to the Study labelled a "snowballing" effect. He testified as follows:

> . . . the book was heavy with stop orders, and they as much as anything, were responsible for the decline with an overhanging volume of market short orders. The bid had to be dropped considerably to take care of the new stop orders that were put into effect.

In reviewing the background of the break the Report describes the year and a half preceding the break as a period of hesitation for the American economy, although the security markets of early 1961 did not reflect these doubts and were characterized by unusual activity in new issues and an atmosphere of speculation. The active merchandising techniques of the greatly expanded securities industry, as discussed in Chapters I, II and III, states the Report, undoubtedly contributed to the general price rises, high volumes and exceptionally high price-earnings ratios of 1961. Investment advice, according to the Study analysis, which had been cautious and "bearish" at the beginning of 1961, switched as the averages rose, emphasizing the tendency of many market analysts to interpret the future in terms of the immediate past. By the end of the year, majority opinion was sharply "bullish" for 1962. The Report notes, however, that the generally rising averages concealed the fact that by the end of 1961 many individual stocks and industry groups were already in their own private "bear" markets and a majority of the industry groups comprising the SEC and Standard & Poor's Indexes had "topped out." Other competing investment media, such as savings banks and the bond markets, were registering strong gains in 1962 as stock prices and volume began to decline.

The Study states that it was unable to isolate the immediate and precipitating "causes" of the break. The history of the break, according to the Study, reveals that a complex interaction of causes and effect, including rational and emotional motivations, suddenly may create a downward spiral of great velocity and force. This, in turn, may change the impact of various normal market mechanisms and thus temporarily impair the market's fair and orderly character. Where the latter situation prevails, the Report states, a public interest in orderly markets, quite distinguishable from any public intervention in the setting of price levels, may come into play.

The Report declares that it would be unrealistic and illusory to believe that the narrow and technical powers possessed by the Commission itself could ever prevent basic price changes. It emphasizes that the Commission's role is primarily regulatory, not economic, and that it has always exercised its powers in such a manner as to avoid dealing with price levels. The Report further emphasizes that any measures that might emerge from the recommended Commission-industry study would be taken primarily by the industry as distinguished from the Commission, which would remain essentially in the role of overseer of self-regulatory action; and that, at most, any such measures would be directed toward ameliorating the impact of specific factors in the operation of market mechanisms that might otherwise accentuate the severity of a market break. While the Special Study did not evaluate the possibilities, the types of intermediate measures to be considered might include such things as limitations on short selling, special provisions in respect to the handling of stop sell orders or market sell orders, and temporary interruption of trading in individual securities under predefined circumstances. The Study suggests that the implications of such actions could be tested in advance through the use of simulation techniques on a computer.

The Study concludes that the implementation of various specific recommendations made elsewhere in the Report with respect to such matters as short selling, the capital position of specialists, floor trading and odd lot transactions should also tend to improve the ability of Exchange mechanisms to function more efficiently in times of stress.

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