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PART 1
INVESTOR PROTECTION

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

EIGHTY-EIGHTH CONGRESS

FIRST SESSION

ON

H.R. 6789, H.R. 6793, S. 1642

BILLS TO AMEND THE SECURITIES ACT OF 1933, AS AMENDED, AND THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED, TO EXTEND DISCLOSURE REQUIREMENTS TO THE ISSUERS OF ADDITIONAL PUBLICLY TRADED SECURITIES, TO PROVIDE FOR IMPROVED QUALIFICATION AND DISCIPLINARY PROCEDURES FOR REGISTERED BROKERS AND DEALERS, AND FOR OTHER PURPOSES

APRIL 3; NOVEMBER 19, 20, 21, 1963

Printed for the use of the
Committee on Interstate and Foreign Commerce

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INVESTOR PROTECTION

WEDNESDAY, APRIL 3, 1963

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1 p.m., in room 1334, Longworth Building, Hon. Harley O. Staggers presiding.

Mr. STAGGERS. The committee will come to order.

The House Committee on Interstate and Foreign Commerce over the years has been constantly aware of its responsibilities under the Legislative Reorganization Act of 1946 and under the rules of the House, to keep abreast of matters within its legislative jurisdiction, a jurisdiction which includes the various laws in the securities field that are administered by the Securities and Exchange Commission.

During the last Congress, the committee, acting through its Subcommittee on Commerce and Finance, under the chairmanship of Mr. Peter F. Mack, again gave careful consideration to the situation in the securities markets and the adequacy of the protection afforded to investors and to the public by the Federal securities statutes now on the books.

Among these statutes is that of the Securities Exchange Act of 1934, which charges the Securities and Exchange Commission with certain duties and responsibilities relating to disclosure of information about listed securities and regulating practices in exchange markets, and imposes certain duties and responsibilities upon national securities exchanges which are required to be registered with the Commission. By amendments to the act in 1938, similar duties and responsibilities are imposed upon national securities associations covering over-the-counter operations. The act, as amended, thus requires that both the exchange and over-the-counter markets should be substantially self-governed by certain rules for the protection of the public in the conduct of their operations.

During the last Congress, for reasons set forth in the committee report (No. 882, 87th Cong.), it seemed to this subcommittee that it was highly appropriate again to review these rules governing the activities of the securities markets to see whether they are adequate to protect investors, to determine just how they are being administered by the exchanges and the over-the-counter associations, and what changes, modifications, or expansions of the rules or securities laws might be desirable in the public interest.

Accordingly, the subcommittee sponsored, the committee approved, and the Congress enacted legislation directing the Commission to make such a review of these rules and to report to the Congress by

January 3, 1963 (later extended to April 3), the results of its study and investigation together with its recommendations, including such recommendations for legislation as it deems advisable (H.J. Res. 436, Public Law 87–196).

Today the Securities and Exchange Commission has made a report to the Congress, which the Speaker has referred to this committee for consideration. We have scheduled this meeting, accordingly, for the subcommittee to hear the Commission present what have been the results of this study and investigation, and what may be its recommendations including recommendations for additional legislation.

The subcommittee fully appreciates the magnitude of the task which was before the Commission this past year and a half. We took occasion to stress in our report on the resolution creating this study that while the language of the resolution is short and specific, the scope of the resolution is very broad inasmuch as the subject matter covered by the rules—or just as significant, not covered by the rules—of the securities exchanges and associations is extremely wide in breadth. We shall be very interested, accordingly, in seeing just how the Commission has interpreted this broad mandate, and just what it is recommending.

It is our purpose here this afternoon merely to hear from the Commission on those portions of its full study which it is submitting today, and get some indication of what is yet to come. In view of the fact that the report filed today has not been available to any of the committee before this time, we obviously are not in position at this juncture to enter into any discussion or examination of it.

Mr. Cary, it is a pleasure to welcome you here; and I assume that you are rather happy to have reached this milepost toward the conclusion of your special study. I see you have your colleagues with you, whom you may wish to introduce; and I know you also will wish to introduce Mr. Milton Cohen who has been in charge of this study.

STATEMENT OF WILLIAM L. CARY, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY MILTON H. COHEN, DIRECTOR, SPECIAL STUDY OF SECURITIES MARKETS, SECURITIES AND EXCHANGE COMMISSION

Mr. CARY. Mr. Chairman, I welcome the opportunity to be here and I would like to introduce my colleagues and also the members of the Special Study who have done so much in producing this volume.

I would like to introduce Commissioners Woodside, Frear, Cohen, and Whitney.

Then on the other side of this first row, I would like to introduce the persons who are the chief staff directors of the Special Study. I will leave the Director himself to the last, but we have here the Associate Director, Mr. Ralph Saul; Chief Counsel, Richard Paul; Chief Economist, Sidney Robbins; and Assistant Director, Herbert Schick. I have beside me the Director of the Special Study, Milton H. Cohen.

Mr. Chairman, I have the honor to transmit the first segment of this report of the Special Study of the Securities Markets. It is submitted pursuant to section 19(d) of the Securities and Exchange Act, which was originally House Joint Resolution 438, initiated by this very committee.

At the outset, we emphasize that although many specific recommendations for improvements in rules and practices are made in the report of the Special Study, the report demonstrates that neither the fundamental structure of the securities markets nor of the regulatory pattern of the Securities Act requires dramatic reconstruction.

The report should not impair public confidence in the securities markets but should strengthen it as suggestions for raising standards are put into effect.

Serious shortcomings are apparent, and the report, of course, has concentrated on their examination and analysis. Yet it is not a picture of pervasive fraudulent activity, and in this respect contrasts markedly with the hearings and findings of the early thirties preceding the enactment of the Federal securities laws. The study confirms the strength of those laws, and the heightened sense of obligation of the financial community.

At the same time, the report makes very clear that important problems do exist, grave abuses do occur, and additional controls and improvements are much needed. The tremendous growth in the securities markets over the past 25 years, and most particularly the increased public participation, imposed strains on the regulatory system and revealed structural weaknesses. Some of these problems resulted from inadequacies in established enforcement machinery, both Government and industry. Others reflect patterns of conduct now tolerated but which upon exposure and analysis appear incompatible with the public interest. Testimony to this effect has been given by many responsible members of the financial community in their comments and most vividly in their adoption of higher standards of conduct without compulsion of law. It is these voluntary higher standards which regulation should reflect and make generally applicable.

Now, 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.

Raising capital from the general public is a marked feature of the American economic system. In this country there are now approximately 17 million shareholders. As the study attests, this phenomenon has been advanced and protected by the Securities Acts, a proven legislative achievement. Yet no regulation can be static in a dynamic society. Unanticipated changes in the markets and the broader public participation should be accompanied by corresponding investor protection.

The importance of the capital markets to our national economic progress does not permit anything less than the most fair and efficient operations. Government and industry regulation, and the efforts of the financial community, must continue to be directed against practices which undermine the integrity of the securities markets and which can only be harmful to the economic growth of this country and to the investors who furnish the funds for that growth.

Now, while the report focuses upon shortcomings in the industry and in the self-regulatory authorities, in certain respects it is an express or implied criticism of the Commission as an institution. The Commission has not fully exercised its powers, nor coped effectively with all of the problems confronting it. But our job, like industry's,

is not to rationalize inactivity but to initiate improvements, and the report of the Special Study will be a force in that direction.

The complete report of the Special Study of Securities Markets will be the most comprehensive of its kind in 25 years. It has been done by separate groups in the Commission designated the Special Study of Securities Markets under, as I have said before, the direction and supervision of Milton H. Cohen.

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 of the Commission. However, the Commission has worked very closely with the study throughout, and has gone over every section of the report. We believe that the report is a thoroughly responsible document. We do not embrace every recommendation as our own, but we do accept them as a sound point of departure.

Now we are transmitting in this small bundle chapters I through IV and chapter IX. The remainder of the report, while nearing completion is not available at this time essentially because of the scope of the undertaking. The chapters submitted in many respects disclose problems calling for vigorous and prompt responses by the Commission and the industry.

The Commission will very shortly recommend to the Congress certain legislative proposals, which I will outline now, where the present statutory scheme appears inadequate. An important part of these reflects our continuing belief in self-regulation as an ingredient in protection of the investor. Certain deficiencies can be treated through rulemaking by either the Commission or self-regulatory agencies. Still others can be resolved only by a more uniform and voluntary adoption of improved procedures by members of the industry.

The report begins where regulation must begin, at the point of entry into the business. It is self-evident that the standards of conduct of the securities industry are vitally dependent on the integrity and competency of its personnel. Obviously no system can be devised which eliminates all potential wrongdoers. But the report of the Special Study concludes that minimal controls furnished by existing regulation are inadequate. Ease of entry is apparent under both Federal law and the rules of the National Association of Securities Dealers, the self-regulatory agency for the over-the-counter market. With the exception of the major exchanges, significant standards of character, competence and minimum capital have not been generally imposed nor has attention been sufficiently directed to the unique problems of supervisors such as branch managers and research analysts. Furthermore, certain sectors of the industry, including most importantly certain distributors of mutual funds and real estate securities and also investments advisers, are not subject to the discipline of self-regulation.

We shall, therefore, recommend to the Congress legislative proposals roughly as follows:

One, authorizing standards of character, competence and financial responsibility as conditions for entry into the business to be established and administered by the National Association of Securities Dealers, notably the NASD, which will complement similar regulation by the exchanges of their members.

Second, requiring all firms and individuals to be subject to the authority of one of the self-regulatory agencies.

Third, granting the Commission direct disciplinary controls over individuals and perfecting NASD controls in this area.

Fourth, providing the Commission with intermediate sanctions over firms and individuals.

Moving on to the second area, selling practices: The heightened public participation in the securities market severely tested the adequacy of controls particularly in the area of selling practices and investment advice. The examples of sales techniques cited by the study show a striking spectrum; from the illegal operations of boiler room to the disciplined patterns of the responsible, reflecting elaborate supervisory procedures and voluntary codes of conduct. Even in the latter which represent high standards of achievement, serious lapses have occurred. Yet it is their best standards which, if universally followed, would result in increased investor protection. Certain excesses also appear to have developed in the investment advisory materials of both broker dealers and investment advisers as evidenced by fanciful recommendations based on little more than mere rumor. Here again, uniform application of the best industry practices would seem to be in order.

In this area legislation is not presently recommended. Powers exist in the self-regulatory institutions and the Commission to advance selling and investment advisory practices.

Going on now to the question of distributions of new issues. The mechanism, practices, and rules for distributions in the securities markets are examined in the report with particular emphasis on the so-called "hot issue" phenomenon that accompanied the active and rising markets of the late 1950's and the early 1960's and involved primarily companies going to the public for the first time. I know by the way this was one matter which concerned this committee when House Joint Resolution 438 came before it.

A record flow of these new issues was another critical trial for both the regulatory pattern and industry practices. The findings of the report do not invalidate this pattern or those practices. At the same time particular weaknesses have developed, and their elimination should strengthen the distribution mechanism without impairing access to the capital markets. Most of these can be remedied by rules of the Commission and the NASD with one important exception. At present a prospectus containing business and financial information about a company must be delivered to the purchasers of the company's stock during a period of 40 days after a registered public offering of that stock. The findings of the report and the Special Study demonstrate that particularly in the case of new issues dramatic price movements may result from uninformed investor action and that minimum exposure of financial and public information is crucial to securing knowledgeable evaluation of these securities. The Commission will, therefore, recommend to the Congress, that in the case of new issues the 40-day period be extended to 90 days or such shorter period as the Commission may prescribe by rule or order.

Now, I should like to move on to the area of broader disclosure provisions. Much of the material submitted here evidences the fundamental importance of adequate disclosure by issuers as a most vital means of investor protection. The report points out the broad range

of problems and abuses in the securities market, including improper selling practices, misleading public relations, irresponsible investment advice, and erratic aftermarkets for new issues which can be greatly mitigated by the more complete availability and dissemination of financial information. The report further demonstrates, as have prior studies, that the longstanding contrast in the disclosure protections afforded investors owning securities listed on national exchanges, and investors owning securities traded in the over-the-counter market is not warranted. Issuers of over-the-counter securities, unlike their listed counterparts are under no obligation to comply with the Commission's proxy rules or, except in certain cases, to furnish annual and periodic financial reports. Another void in investor protection in the over-the-counter market relates to insider trading. An insider of a listed company must report his transactions in the company's stock. His short swing trading profits in the stock are recoverable by the company and he is prohibited from selling the stock short. The policies expressed in these sections should also be applicable in the over-the-counter market.

Accordingly, the Commission will recommend extension of those sections of the Securities Exchange Act which provide for the filing of annual and periodic reports, compliance with the proxy rules, and protections against insider trading to certain companies whose secuities are traded in the over-the-counter market. A phased program of coverage would gradually include all those companies with 300 or more shareholders. In the case of bank stocks which appear to account for 20 percent of the issues of the over-the-counter market, if Congress so desires, disclosure requirements could be administered by the appropriate Federal bank regulatory authorities in order to integrate these controls with the existing pattern of bank regulation.

Finally, an analysis of the over-the-counter market will be submitted in our complete report; it is not available, may I say, in this material that is coming to you today. At this time, however, we wish to inform the Congress that we shall propose a legislative recommendation essentially directed to the wholesale quotations system in that market. At present the National Quotation Bureau dominates the business of over-the-counter wholesale quotations.

The bureau, a private corporation, I sometimes refer to it as a one-man public utility, is not regulated by any agency, Federal, State or self-regulatory. Despite the efforts of the bureau, which is operated with a consciencious regard for the responsibility which its function and dominant responsibility entails, this vital segment of the over-the-counter market has had inadequate controls. Numerous abuses involving quotations have been perpetrated by broker-dealers. Moreover, developments in electronic data processing have foreshadowed the emergence of new and perhaps revolutionary quotation systems. In view of the vital significance which these systems can have to the functioning of the over-the-counter market, they should not be allowed to emerge without due regard to the welfare of the market and to the public interest.

Accordingly, the Commission will recommend to the Congress that operators of quotations systems, like the National Quotation Bureau, be required to register with the Commission and adopt and enforce rules of fair practice in the use of their systems just as is presently the case with the self-regulatory agencies.

Now, we have described a substantial part of the legislative measures which we shall recommend to the Congress this year. A few others will subsequently be proposed. A very important one of these might concern certain aspects of security credit regulation which would be submitted only after full coordination with the Federal Reserve Board.

Not all of the study's legislative recommendations in the chapter transmitted have been adopted by the Commission. These are the subjects of our continuing study and may be proposed to the Congress at a subsequent date.

To secure the benefits of industry views on our legislative proposals, we shall immediately request leaders of the financial community to form liaison committees, and a letter will go out to that effect.

The enactment of Public Law 87–196 and the very existence of a special study have assisted in the creation of a more salutary environment and have resulted in numerous important developments already. The American Stock Exchange has undergone an extensive reorganization and I have reported on that to this committee. The New York Stock Exchange has commenced a program for improved controls over selling practices, and initiated new qualification standards. The NASD has undertaken a comprehensive revision of its bylaws and rules of fair practice. Broker-dealers have reviewed and altered their systems of supervision. It would go too far to assert that all of these and other numerous changes are the direct products of the special study and of the initiating legislation. Yet it would be difficult to deny that their existence has at least produced a reevaluation of existing practices and procedures by the industry as well as the Commission which can only be beneficial. In other words, the financial community has taken the opportunity to make its own special study with valuable consequences.

As has been pointed out, the report of the Special Study is only a prelude. Our legislative recommendations to the Congress will be an important first element, indeed a prerequisite for needed improvements. However, much of the action must be taken through the self-regulatory agencies, through exercise by the Commission of existing powers, and through the influence of leaders in the securities industry to raise standards.

In concluding I and my colleagues want to express our appreciation to the members of the financial community, the self-regulatory institutions, and the numerous companies that fully cooperated with the Special Study. I am sure they are glad the questionnaire period is over. Many gave generously of their time and manpower in assisting the study to gather information and viewpoints.

Finally, I do want to thank the staff of the Special Study, a great part of which I believe is in this room today, and I particularly commend to your attention the craftsmanship and the high standard of conduct of this study by its Director, Mr. Cohen.

Thank you.

Mr. STAGGERS. I believe you have Mr. Cohen, Director of the Special Study, who will make a report. Perhaps now there might be some questions that the committee might like to ask you briefly on this. In connection with this I have one or two that I would like to ask.

Mr. CARY. Yes, sir.

Mr. STAGGERS. This report is certainly a voluminous report and you have boiled it down as briefly as possible; however, on the subject you have been studying I would like to ask this.

Are the rules of the National Securities Exchanges and National Securities Association including rules for expulsion, suspensions, or disciplining of a member for conduct inconsistent with just and equitable principles of trade adequate for the protection of investors?

Mr. CARY. Are they adequate? In many areas we feel that the powers of the NASD to which you referred, and the exchanges are adequate to cover many of the problems that we have raised here. In some areas they may not be adequate, and in that respect we are coming to you for legislation to increase their powers and to a limited extent to increase our powers. By and large, I would say that the bulk of the recommendations made in this study can be handled under existing powers of the Commission and the self-regulatory institutions.

I think, however, the legislative recommendations we have asked for are essential prerequisites to a proper exercise of those powers.

Mr. STAGGERS. To follow that up I would just like to comment on that. I was going to say, Can these rules be made effective today or their administration be effective by the exchanges and the NASD? That is, I mean, is the policy incorporated in the act of chief reliance on self-regulation a realistic policy today?

Mr. CARY. Mr. Chairman, I have spoken on this question of the question of self-regulation in the securities industry, recently at a speech before the Investment Bankers Association in late November.

Mr. STAGGERS. I was going to come to that.

Mr. CARY. In that respect I might say we subscribe to the theory and policy of self-regulation, which I think has been a part of our laws ever since 1934. This doesn't mean we shouldn't have some oversight over the self-regulatory institutions because I think public oversight is necessary.

Just as Congress itself has oversight over the Securities and Exchange Commission, we think that there has to be some kind of an oversight on our part with respect to self-regulatory institutions.

Our belief in the principle of self-regulation was demonstrated most fully in connection with the American Stock Exchange investigation which we made some time ago. There we laid the responsibility in the hands of that institution to reconstitute itself and it did so effectively.

Mr. STAGGERS. I notice in that speech you mention, in November when you did speak to the investment bankers, that you referred to the stock exchange as being a private club, and you felt it could be relied upon to a great extent to self-govern itself, and I just wondered from the whole thing after you have had this study that you still feel that way and I think you have answered that you feel that is——

Mr. CARY. I didn't quite go so far as you stated. I said it had certain characteristics of a private club and that is as far as I went.

Mr. STAGGERS. I just noticed the expression "private club."

Mr. CARY. It is a very catchy phrase, I gather.

Mr. STAGGERS. Does the Commission propose to make changes in the rules of the exchanges and the NASD?

Mr. CARY. Well some of our recommendations will undoubtedly mean actions to be taken by the National Association of Securities Dealers and the exchanges. I might say, as I indicated at the end of my discussion, that they already have taken a number of important beneficial steps.

In other words, since this Special Study started, there have been a number of changes that have been made which are moving along in the direction which we have in mind.

Mr. STAGGERS. Well now, I was going to say when you were through here, your Commission is going to recommend changes in the statutes then?

Mr. CARY. Certain changes, limited changes as I have outlined them, about four in number, four general areas in number, yes, sir.

Mr. STAGGERS. Mr. Chairman, I was struck by the Wall Street Journal story about Commissioner Cohen's remarks in Boston 2 weeks ago to the effect that the SEC won't recommend new legislation to Congress until it has studied the report thoroughly, and conferred with the securities industry.

In this connection, I recall that you issued a study report on the American Stock Exchange which you talked about. Has the report of the staff made to you—I direct your attention to the fact that although I am sure you are aware of it that your report today is a report to the Congress of the Commission, and not of the Commission staff, and that section 19(d) of the Securities Exchange Act calls for you to give us your recommendations today of such legislation as you deem advisable.

I appreciate that you may not have been in the position to do all of that today, and we have discussed that. But I wish you would give us an indication of when you can complete this assignment, I mean within the next week or two?

Mr. CARY. Yes, sir.

Mr. STAGGERS. On this phase of this report?

Mr. CARY. I would like to answer that in several parts, Mr. Chairman.

The Special Study is already working nights; I think we can produce the balance of this report by the end of May. That would be 2 months.

As to the recommendations, we have already outlined to you in large part the legislative recommendations that we have in mind, not only in respect of this part of the report but also the second part of the report.

Now as to when those legislative proposals can get before you, it is our opinion that we should have them in the form of a draft bill with appropriate statements of explanation, on say not later than the middle of May. We recognize that, unless these proposals are received by Congress quite soon, we are told by you and the chairman, they would not be considered by Congress in this session. Therefore, we believe that we owe you a responsibility to have them here by that time.

Mr. STAGGERS. Mr. Chairman, in connection with that, the understanding was I believe, that you would make recommendations on this phase of the report to this committee so that we could be acting and working upon those.

Mr. CARY. Yes, sir.

Mr. STAGGERS. We are hopeful that you will have that in the next 2, 3, or 4 weeks at the outset.

Mr. CARY. Well, we will do our very best. We are working on them right now. We haven't been waiting until this report was in front of you; we have been working up drafts. We didn't think it was proper to go, for instance to the industry and have discussion until after the report had formally been presented to Congress.

However, today, I sent a letter, after this report became public, to various members of the industry asking them to form committees in connection with the subject matters which we are considering as legislative proposals.

Mr. STAGGERS. I will only only take one more question and I would like to stress to you the importance of this being submitted to the Congress as soon as possible, so we can act on it.

Mr. CARY. We will do our very best.

Mr. STAGGERS. Just as soon as you do we intend to call hearings and have every phase of anyone who is related to the industry in any way in on both sides for their recommendations.

Mr. CARY. We welcome that opportunity.

Mr. STAGGERS. Mr. Dingell, do you have any questions?

Mr. DINGELL. Yes, Mr. Chairman.

Mr. CARY. I am quite an admirer of yours. From what I have been able to ascertain in the very brief period I have had to study your comments on this, there are some questions, though, which concern me with regard to these circumstances.

On page 3 of your communication to the committee here you state as follows:

> We do not embrace every recommendation as our own but we do accept them as a sound point of depature from proposals to the Congress for rulemaking by the Commission and by the self-regulatory agency and for discussions with the industry.

Then I note that the language of your legislation setting up this investigation said and I am quoting now:

> The Commission is authorized and directed to make a study and investigation of the adequacy for protection of investors of the rules of national securities exchanges, national securities associations, including rules for the expulsion, suspension, or disciplining a member for conduct inconsistent with just and equitable principles of trade. The Commission shall report to the Congress on or before January 3, 1963.

We have subsequently extended that date.

But the point I am making is this: you say this is a report of the Commission and yet you say it is not a report of the Commission. By statute you are to bring us the report of the Commission and not a report of a group within the Commission which is in effect reporting to the Commission, which, in turn transmits this matter to the Congress without endorsement of the Commission of the principles and statements therein.

I am sure you recognize this puts us in a position of having somewhat of an inconsistency between your comments here today, and the language of the statute which directed the investigation.

I was wondering if you would want to make a comment on it.

Mr. CARY. Yes, Mr. Dingell; there appears to be some inconsistency. The question comes up when you are making an exhaustive study,

as the Special Study has of the industry as a whole; their work, of course, has to be put together and then we have to go over it.

Now, in some areas we found that we perhaps might not have gone so far on this first thinking it through as they did in their recommendation. But on the other hand, in each case, we went over it and we decided it was a very responsible recommendation. It was a matter for consideration.

Now, out of that then, we have culled certain recommendations which we have adopted as our own. They represent, I would say, a great majority of the recommendations in the field of statutory proposals of the Special Study. Those we have committed ourselves in this letter of transmittal to bring before you as our own legislation.

Now, with respect to rulemaking, there are many suggestions for the exercise of our existing power.

We will gradually in this forthcoming year propose rules carrying out a great portion of these. I won't say which ones at this moment because I can't go over them in detail at this particular hearing. Those rules will be the subject of discussion with the industry as is required under the Administrative Procedure Act.

By and large, I would say we, as a commission, have committed ourselves to what we regard as most of the major legislative recommendations and they are a part of this letter of transmittal. We have also said that we have been over this with great care. Perhaps we wouldn't have said it exactly the same way; we just haven't had time to rewrite it ourselves. When we knew it was being written and handled responsibly, we left it as their report with the statement we stand behind it as a responsible document.

Mr. DINGELL. I see.

Now, Mr. Cary, I have very high regard for you and the members of the Commission. But coming back to the same point, I note there is nothing in the language of the statute, section 19(d), which authorizes and directs the Commission to submit to the Congress a report of this kind. The Commission was supposed to submit to the Congress according to the language of this statute a report which would be in effect its own report which it would endorse and be prepared to stand on whether it be by majority vote or otherwise, rather than what is in effect a submission to this committee and to the Congress of what might be characterized as perhaps a rump report of some kind.

I hope you will clarify that for me because I think this is a very important point. This goes right to the very question as to whether the Commission has in effect complied with the provisions of the statute or whether it has failed to do so.

Mr. CARY. Well, sir, we feel that, first of all, any Commission acts through other people. We made an immense effort to get the most highly responsible people we could, and I believe we have succeeded admirably. Indeed, I believe that the SEC had the highest grade law firm in Washington in the thirties and I like to believe we have reproduced that in this Special Study.

Therefore, we started off with people whom we regard very highly. Secondly, they have produced what we think is an exceedingly thorough piece of work.

Now, for us to go through it piece by piece—and we do have differences of views among ourselves on certain minor matters, but not on

the major matters—for us to go through and resolve each of them would have taken more time than we think is proper in view of the fact that we wanted to get this thorough report out in front of you. I would say we regard the report as a responsible document; we are not just submitting it as the report of the Special Study, but something that we have been over and regarded as thorough and responsible. I think under those circumstances we have approximated, although I quite freely confess to you we have not exactly met, what you regard as the report of the Commission and nothing more.

Mr. DINGELL. You can see the concern of the committee, I think, on this point. I concede everything you say with regard to the responsibility and the way it was conducted and from what I have been able to discern it is a remarkable document from the point of view of technical accuracy and care and the quality of the people who put it together.

Mr. CARY. This is only 40 percent of it, too, I might say.

Mr. DINGELL. Yes; I recognize that. But what I am coming around to, the clear language is the Commission is authorized and directed to make a study, and as I read it, that says "The Commission shall report to the Congress," and then I note a qualification in your comments with regard to the Commission in whether or not this is in effect the Commission's report or whether it is in effect a transmittal by the Commission of a report of the Special Study Group.

The statute imposes very clear responsibility on the Commission. I am sure you understand that and while I am certain this is a very valuable document, and I am sure the Commission at appropriate points endorses it and I am sure will be of immense value to the Congress and the country, I still note some measure of qualification in your comments and that is the thing that I wanted to particularly direct your attention to.

It is my feeling, very frankly, Mr. Cary, that this report submitted as the report of the Special Study Group does not constitute compliance with the language of the statute.

Mr. CARY. Well, I freely confess that within your definition as you have described it, perhaps it isn't exact compliance. I do think that I would regard it as responsible compliance. It may be deemed our work in that we have, as I say, been over the report most thoroughly. Some of the words are our own, but by and large with a product of this magnitude, 1,600 pages, and it is only 40 percent, we simply felt that our role was to make sure that it was being handled and developed along the lines which we originally prescribed and that the product itself was fully responsible.

Mr. DINGELL. Mr. Cary, I would like to continue this questioning but I would just like to conclude with this one question: Am I incorrect in my interpretation of the statute then?

Mr. CARY. Your interpretation is a perfectly proper one. I would not quarrel with it.

Mr. DINGELL. I ask you for information. I consider myself a lawyer.

Mr. CARY. You are indeed a lawyer. It is to be a report by the Commission, and the way we have framed it we don't say in those precise terms that it is a report of the Commission. Your point of criticism is perfectly proper but I think that ours is a responsible way

of meeting the need you expressed within the time Congress has expressed, that is all.

Mr. DINGELL. Thank you very much.

Mr. STAGGERS. Mr. Glenn?

Mr. GLENN. Mr. Cary, I want to say that the report which you have given us in part appears to me to be good but we are looking forward, of course, to having the complete report. I am particularly pleased to compliment you and your staff and your brother Commissioners and the staff of Mr. Cohen and himself on what they have done and I am looking forward to getting into this and seeing what has been brought out.

I am particularly happy to notice on page 8 of your statement where you say, "To secure the industry views on the legislative proposals you proposed to establish liaison committees" I think this is very good and I think it would be perhaps even better if you would attempt to keep these liaison committees on a permanent basis for future problems which may arise between you and the industry, or within the industry, and it seems to me through that cooperation we might avoid some pitfalls that may show up in the future.

There is one more thing I would like to comment on. I notice there in the 1962 report of the National Association of Securities Dealers which was just sent to me, they remark in the report that they have established a national over-the-counter clearing corporation and that this proposes to establish a clearinghouse which will probably start some operation in the summer of 1963.

Is this the result of your investigation and something that you have done with the National Association of Securities Dealers or did they come up with this of their own accord?

Mr. CARY. In general, I would think that this is not necessarily the product of this Special Study. It is something, by the way, we strongly would support. This is one of the segments, for instance, of the work of the National Association of Securities Dealers, which is moving them out into new areas. Clearance is the arrangement by which the securities get from, shall we say, the ultimate seller to the ultimate buyer with more speed and facility.

Now, that kind of thing is something, of course, that we would strongly support. I wouldn't say that this Special Study is responsible for it but it is a demonstration of a further area into which a self-regulatory institution, namely the National Association of Securities Dealers, is getting and effectively working it out. This is the kind of thing we would sponsor.

Mr. GLENN. When this is finally set up would this be in effect similar to the Stock Exchange of New York and the American Stock Exchange so it would be actual dealings in the marketplace and reports given out every day as to what the market is on over-the-counter securities?

Mr. CARY. No, sir; the clearing is really a technical, a mechanical job. The New York Stock Exchange has a New York Exchange clearinghouse, clearing corporation, I believe, and this is going to be a counterpart to that.

May I ask Mr. Loomis, who is the Director of our Division of Trading and Exchange, can speak to this point. He might want to clarify it if I have made any errors; may I just check with him?

Mr. LOOMIS. I don't think there is much to add to what the Chairman has said, which is a complete explanation. The clearing corporation will not necessarily, at least, produce figures as to prices and volume, though it will facilitate developing those figures particularly as more dealers make use of those facilities.

Mr. HARRIS. Mr. Chairman, I think the record should show this is Mr. Philip Loomis, Director——

Mr. CARY. Division of the Trading and Exchange.

Mr. HARRIS. Of the Securities and Exchange Commission.

Mr. STAGGERS. Let the record so show.

Mr. GLENN. What effect will this new corporation have on this one man setup which you made a comment on in your report?

Mr. CARY. The area that I was referring to, Congressman Glenn, is the matter of quotations.

The clearing operation to which I have referred is the matter of transfer and delivery of securities. It is a different area of activity. We will recommend the idea of moving the quotations system regulation into somewhat the same pattern as exists with respect to the National Association of Securities Dealers.

Mr. GLENN. You feel this is a step in the right direction?

Mr. CARY. A step in the right direction, yes, sir, very definitely.

Mr. GLENN. Thank you very much, Mr. Chairman.

Mr. STAGGERS. Mr. Long?

Mr. LONG. Chairman Cary, were you satisfied and was Mr. Cohen satisfied with the cooperation of the financial community during the conduct of your study?

Mr. CARY. I will let Mr. Cohen speak but first of all, I would say the general impression we have had is complete cooperation. We have burdened them with a heavy number of questionnaires and they have responded very well.

Maybe Mr. Cohen would want to add to that.

Mr. MILTON COHEN. We have had excellent cooperation all the way up and down the line. Our questionnaires were responded to very fully. We imposed on lots of people for interviews and private hearings on so on, and we have had help all the way I think, as a matter of fact, it is some indication of self-regulation working that the industry has, to the extent it has, taken part in this study.

Mr. LONG. What do you think, Mr. Cohen, will be the reaction of the financial community to the major legislative proposals that you intend to make?

Mr. MILTON COHEN. Well, I think the major recommendations will have widespread agreement. I assume there will be some disagreement on some things. We attempt, by and large here, to bring the general level of performance and standards up to the best levels and I would think that there will be some difference of opinion within the financial community but I think most of the recommendations ought to have widespread support, sir.

Mr. LONG. You don't see a revolt by the financial community to the proposals that you are making?

Mr. MILTON COHEN. I don't expect any such thing, no, sir.

Mr. LONG. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Cary, we have waited a long while for this and you are probably going to wait a long while for us to digest the topics that you have thus far furnished. I wondered if there was any particular significance in your furnishing chapter 9 before the other chapters.

Mr. CARY. In large part it is fortuitous in that it was completed before some of the others and we decided that since it is an exceedingly important chapter, Congressman Keith, we might as well get it out at this time.

One of the reasons that it is important is that it is one of the phases in which we ask for legislation. Therefore, we thought as much of the material as was available at this present time to support our legislative proposals, should be transmitted at the earliest possible date.

Mr. KEITH. I don't recall any previous testimony on this subject by you or other Commissioners during my 4 years in Congress.

Mr. CARY. Chapter 9 has had a long history in the SEC and before Congress. This is a more careful brief perhaps than we have every had before, but it is to demonstrate the need of something that was called Frear-Fulbright legislation at an early time. It is the need for broader disclosure requirements, for proxy regulation, and for insider trading rules with respect to a largen umber of stocks which are on the over-the-counter market.

At the present time, as you know, many companies have gone public and at that time they may file a registration statement but then from then on information has been sealed off. We are here bringing up a subject which the SEC has for a long time thought was a very essential ingredient of investor protection.

Mr. KEITH. In chapter 9 you seem to have singled out two specific kind of companies, stock of which is traded over the counter; namely, banks and insurance companies.

Mr. CARY. In chapter 9 we take those up separately, because in preceding history the issue came up as to whether or not those types of companies should be exempted. For that reason we felt we should respond to that issue which has been before Congress at an earlier time. We now, as you notice here in this recommendation, say that, although we believe that sections 13, 14, and 16 of the Securities Exchange Act should apply to over-the-counter securities generally, the enforcement, if Congress so desires, with respect to bank securities could be handled by proper Federal bank authorities.

Mr. KEITH. You mentioned that you would be bringing legislation to the Congress soon. I would assume it would be in the areas covered by your first chapters rather than those in the chapters which will follow?

Mr. CARY. That is in large part true. I don't want to commit myself to everything we are going to propose to you although this is the bulk of it. One item which we have mentioned here is the over-the-counter quotations systems. That is a part of a later chapter, but we have outlined it here in order to let you know.

Another area that we will probably get to is security credit regulation; that is, certain aspects of margin requirements. But we cannot bring that to you immediately because of the necessity to coordinate with the Federal Reserve Board. Therefore, those are two areas not discussed in the first part of the report which legislation may be submitted on.

Mr. KEITH. A lot of your spadework with reference to the mutual funds has been done by the Wharton School report. I gather that, after studying that report, you didn't find it imperative to treat mutual funds either in an early chapter in your report or in an early legislative proposal.

Mr. CARY. That is correct. We have the Wharton School report that we feel we have to give very thoughtful study to; we have a group in the staff that is doing that, quite apart form the Special Study.

Secondly, the Special Study itself has undertaken only one segment of the matter of mutual funds and that is largely selling practices.

That is the major area with which they are dealing.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Van Deerlin, do you have any questions?

Mr. VAN DEERLIN. No questions.

Mr. STAGGERS. Mr. Bennett, do you have any questions?

Mr. BENNETT. Thank you, Mr. Chairman, I have one or two questions I would like to ask. I was very interested in this statement of yours, Mr. Cary.

I am wondering if during the course of your investigation you had occasion to look into the situation with respect to private offerings where you are not subject to the registration provisions of the act and which later get into the hands of the investor public but without having had the benefit of the act.

Mr. CARY. I think I might, in view of that getting into an area of the report, ask Mr. Cohen to speak to that.

Mr. MILTON COHEN. We do in chapter 4 deal with the subject of unregistered distributions and we also have some comments about the intrastate exemption; the area of private offerings as such is not one we have gone into, Congressman.

Mr. BENNETT. Don't you feel that is a subject to merit some attention. Our committee 6, 7, or 8 years ago held some hearings and talked to your Commission about this matter. I don't recall that we had any evidence of specific abuses with respect to these offerings but I had the feeling and I think other members of the committee had the feeling that these private offerings circumvent the intent of the act.

Now, it may be true they are carefully screened and all that sort of thing, but eventually they get into the hands of the investing public or very often they get into the hands of the private investors and when they do he has got something that he—he has bought something that he may believe had all of the protection of the Securities and Exchange Act and he is mistaken, is he not?

Mr. MILTON COHEN. He may be; yes, sir.

Mr. BENNETT. Don't you think that is a field that the Commission might devote some of its attention to? As I say, I don't have any evidence of specific abuses but just on the general proposition of whether people who get those kind of securities are being adequately protected or not.

Mr. MILTON COHEN. This is a field which, as I know from my private practice and since I have been with the Commission, has received a lot of the Commission's attention as a matter of admin-

istration and enforcement. We excluded it from the Special Study because we had to draw some lines somewhere. We have made a very broad study but we could not do everything and this was simply a subject we decided not to look at separately. I really wouldn't have any further comment on it since we haven't made any particular examination of it, sir.

Mr. CARY. Congressman Bennett, maybe I could ask Mr. Woodside, my colleague, to speak briefly to that. I think he has had some discussions with you on that matter over some period of time.

Mr. BENNETT. Yes, he probably has.

Mr. WOODSIDE. Mr. Bennett, the subject of the private placement of securities has been one that has held the attention of the industry and the Commission ever since the Commission was organized. I think it is fair to say that the great bulk in terms of number of issues, in dollar volume of privately placed securities, are an institutional character and are sold in the first instance and largely held by the big institutions such as savings funds, insurance companies, pension funds.

We did encounter some years ago what we conceived to be a problem in the field of convertible debt securities. We concluded that the private placement of debt securities, convertible debt securities, with institutions did result frequently in an evasion of the Securities Act principles because of the fact that the institution taking the convertible debt would hold it until such time as the market price of the underlying stock indicated a substantial profit, at which time there would be a conversion and a sale of the underlying stock by the institution into the public market. Or there would be a sale of the convertible debt security to a group of bankers who would then convert and distribute.

We concluded that we could deal with that aspect of the problem within our own rulemaking powers, and we did adopt rules within the past 2 years, which, in effect, said that a conversion under those circumstances and sale to the public was a transaction that was so closely connected with the issuer that registration was required.

Since the adoption of that rule we have had numerous registrations of the securities of the very type you mention.

Now, it is true, I suppose, that there is a certain unknown amount of the private placement of securities in smaller issues and sometimes in equity issues, and we frequently receive inquiries from the holders of those securities as to whether there is a registration problem. We frequently express the view that there is and as a result of that registration occurs.

I think it is fair to say we have not felt that we should come forward with any recommendation for the blanketing in under the Securities Act of privately placed securities, generally, because of the fact that usually they are of an institutional grade.

If you remember in the 1941 amendment program, the industry strongly supported the proposal that all privately placed securities be registered above a certain size.

I think really that proposal arose more from competitive reasons perhaps than others.

Mr. BENNETT. I didn't want to take a lot of time on it here but I just wondered if the Commission was taking any look at it, whether the

Commission had looked into that problem because I know we were concerned about it here and I am still concerned about it. It seems to me whether the private placement issue eventually gets into a private pension fund or institution, all of that, the equity is finally held by the private investor at the end, somewhere down the line, and it just seems to me that that type of security ought to be treated the same way as any other security and made subject to the registration provisions of the act.

I just have one other question, and that is whether you looked into the adequacy of the capital requirements of brokers and dealers with respect to the ratio of their assets to the securities of customers that they hold which they would have to make good on in the event or be liable for if demand was made upon them.

Some years ago, it was the rule of the Commission that the ratio that the dealer had was 25 to 1 or 1 to 25. In other words, he could have $25,000 of my securities and have as a pledge to redeem those in the event they might have to be redeemed the amount of $1,000.

Is that still the rule or have you looked into that?

Mr. CARY. I will start with that one, Congressman Bennett, and then, perhaps, I might have Mr. Cohen add to it.

I would like to add, first of all, it is now 20 to 1.

Mr. BENNETT. Twenty to one?

Mr. CARY. Yes; and that is the way it is currently being administered. We have looked into these questions of capital, and one of the recommendations of the special study to which we give full support is the idea of having some kind of minimum capital.

There would be a minimum capital with respect to broker dealers, and a different amount—this is not a ratio, by the way, this is an absolute sum—with respect to underwriters. I will ask Mr. Cohen to add anything he may choose to with respect to the net capital ratio point.

Mr. MILTON COHEN. We do have in our chapter II, as Mr. Cary said, a discussion of capital, minimum net capital, as an essential ingredient in the qualification of broker dealers.

Then in chapter III there is a section dealing with the financial responsibility of broker dealers in the sense of holding customers' funds and securities, and the pledging and lending of those, and so on.

In this area we make some recommendations to bring the practices that are not quite up to the strongest, to the best level, but we are not making any basic recommendations in this area, sir.

Mr. BENNETT. There have not been many broker dealers who have gone bankrupt in recent years, so the problem, I assume, has not really been brought into focus. But we did have some years ago several firms, one I remember out West, the Badger Co. or some such name as that, which went bankrupt, and a lot of people were left holding the bag, and one of the reasons for it was this, what I regard as, a loose, inadequate ratio between the assets the broker dealer must have in relation to what he would have to pay off to the customer if need required it.

It seems to me if the Commission hasn't looked into that subject carefully in this investigation it ought to do so because while conditions are good, times are all right, these kinds of situations do not develop. But if you come upon a difficult period you might easily run into a situation where you would have a lot of bankruptcy among

broker dealers and a lot of unnecessary losses to the investor who had left the securities with him.

Mr. STAGGERS. Is that all?

Mr. Curtin, do you have any questions?

Mr. CURTIN. Thank you, Mr. Chairman, just a few questions.

Mr. Cary, I believe you said this report represents 40 percent of the final report?

Mr. CARY. Yes, sir.

Mr. CURTIN. Is it your intention to submit the remaining portion of the report at one time or over a series of presentations?

Mr. CARY. Well, at the maximum it would be in two parts. Logically the first part that ought to come out next, Congressman Curtin, would be chapters V, VI, VII, and VIII, because they are a group that has covered the whole question of the markets, the over-the-counter market and the exchange market.

Whether or not we will put those out before the balance which Mr. Cohen will outline is a question we have not yet decided on. I think it is really a practical problem.

If we complete V, VI, VII, and VIII, which is a package, in considerable time in advance of the others, then we would put it out first, but we have not yet finally decided this point. But the maximum is that it would be out in two additional packages.

Mr. CURTIN. When do you anticipate you will be able to give us the final report?

Mr. CARY. At the end of May.

Mr. CURTIS. By the the end of May?

Mr. CARY. Yes, sir.

Mr. CURTIN. Mr. Chairman, I believe I will forego any further questions until I have had a chance to digest this rather voluminous information presented to us today.

Mr. STAGGERS. Thank you very kindly.

Does anybody else have any questions?

Mr. HARRIS. Mr. Chairman, I just want to say that as other members have indicated, this is quite a voluminous report, and there obviously is a lot of meat in it. It means there is a lot of interest in it, too.

You are making these available to the public today?

Mr. CARY. Yes, sir.

Mr. HARRIS. They became a public document at noon today, at 12 o'clock when they were filed with the Speaker of the House and the Vice President of the United States.

I want to compliment you, Mr. Chairman, and your Commission and your staff for the tremendous job that has been done pursuant to the direction of the Congress on this problem which has been the first time in 25 years that it has been given a very thorough study and a report made.

As I said to my colleague, Mr. Dingell, a moment ago, in raising questions about it, I personally think that you did the only thing that you could in carrying out the direction of the Congress because when you set up the special staff to study this problem under the direction of the Commission, you gave them a great deal of independence in doing so. As I understand it, in carrying out the responsibilities you, as a commission, followed it pretty closely all the way through.

Mr. CARY. Yes, sir; that is correct.

Mr. HARRIS. I think to file the report developed in this manner is appropriate, and a thing to do under the circumstances because had the Commission tried to take it upon their knees down there and write all of it, there obviously would have been a lot of criticism throughout the country, and justifiably so.

Even though it may not meet the entire satisfaction of everybody, I do think that the Commission has a direct program here that I know there has been a lot of interest in, and it will have a great bearing in the future. I also do want to look forward to the receipt of the other two parts to this, I believe.

Mr. CARY. Yes, sir.

Mr. HARRIS. We will endeavor to make a similar arrangement, Mr. Chairman, for this subcommittee to receive these, as we have here, because I am sure my colleagues realize, as you do, that there are difficult problems to work out with the printing and everything in connection with the usual procedures. The other body, the Senate, is interested, too, and we have to make these arrangements and work them out to the best interests of both sides of this Capitol and, thus, to the American people. So we will try to work that arrangement out again when it comes up with the other two parts.

It is going to be, Mr. Chairman, the procedure that arrangements have been made for the printing of this into a House document. There will be so many copies made available for the House side and this committee, so many will be made available for the Senate document room and the Senate committee. There will be a number of copies that would be available to the public to be purchased, I believe, through the Government Printing Office.

I make this statement because my office has been covered up today with requests for copies, and they have been calling all over the Hill, even the Parliamentarian, trying to get copies. In order to try to save my shop a lot of time and a lot of trouble, I make this public statement so that the public can be advised of what the situation is going to be.

In addition thereto, I understand that you have in your office a great number of copies that will be made available even today, is that right?

Mr. CARY. We have had a few hundred altogether produced, a great many of which we have brought over to your committee and to the Senate committee. We have also made available a very substantial number of copies to the press because they, too, seem to have a considerable interest in this.

I think we will have a few copies left, but they will not be in the magnitude to meet the demand. However, we understand through your cooperation that it will be out of the Government Printing Office in a very short time and will be printed up immediately.

Mr. HARRIS. Yes. It will go on today and, Dr. Stevenson, would it be ready tomorrow?

(Discussion off the record.)

Mr. HARRIS. Well, it won't be printed as fast as I thought it would be.

Mr. CARY. It won't be too long, I assure you.

Mr. HARRIS. Well, I said something to Mr. Hemphill a while ago that some evening just before I get ready to retire I will take this up and read it over.

Mr. CARY. We have press summaries, Congressman Harris. We have got a press summary, as you will notice there, which attempts to outline it in roughly 15 pages, all the material that is available, and those are available in your hands and in the hands of anybody who wishes them.

Mr. HARRIS. You should get enough copies of that to satisfy everybody.

Now, I do not want to go on with this, Mr. Chairman, because we have got another committee to go back to and try to complete our work today. But one important matter about the legislative proposals here: I don't see how you could expect to develop and complete your legislative proposals until the entire report is filed and, after all, if you say that is going to be only a couple of months, our experience around here is that it takes a little while for legislative proposals to get started and get their way through the machinery.

Mr. CARY. Mr. Chairman, the legislative proposals will, in large part, 80 percent of them, let's say, stem right out of the material we have available to you today.

Mr. HARRIS. All right.

Mr. CARY. And, secondly, and the one area particularly we referred to that is not a part of this first report—the material underlying the quotations statute—we would file with you at the time we file the proposed legislative proposal itself. We would file with you a substantial memorandum to support this statute; and then, say, 4 weeks later would come the full report giving it.

So I think we will have for you available supporting data with respect to each of the matters on which we have a legislative proposal.

Mr. HARRIS. Well, we want your proposals as early as you can get them to us, but we do not want them to come up in part and piecemeal.

Mr. CARY. I understand.

Mr. HARRIS. For legislative purposes.

Mr. CARY. We certainly will have them all in a group.

Mr. HARRIS. That would be the better way to do it.

Mr. CARY. Yes, sir.

Mr. HARRIS. Do you deal with odd-lot securities?

Mr. CARY. The odd-lot material will be covered in a chapter, I think it is VI, which deals in general with the exchanges. There are certain problems dealing with the exchanges which we would want to cover, the specialist problem, the odd-lot problem, the floor trader problem, and problems of that kind. Those will be covered at that time in chapter VI.

Mr. HARRIS. When do you intend to file your annual report as of the year ended June 30, 1962?

Mr. CARY. As soon as the Government Printing Office will permit it. It has been over there, and I understand it has a low priority.

Mr. HARRIS. Well, do you think it ought to be gotten out before this?

Mr. CARY. Perhaps I should make further efforts to try to get it. I think it should be out, and I'm sorry it is not out, but it has been in their hands for some time. I cannot tell you the exact date. Perhaps somebody here can. I'm afraid the man who is in charge, who actually submitted it, is not here, but I know it has been in the hands of the Government Printing Office for weeks.

Mr. HARRIS. Just one other thing, Mr. Chairman. I believe it would be advisable for Mr. Cary, the Chairman of the Commission, to supply for this record at the appropriate place the members of the staff who made this study under the direction of the Commission.

Mr. CARY. I would be delighted to do so.

(The information referred to follows:)

STAFF OF SPECIAL STUDY OF SECURITIES MARKETS

[NOTE.—The staff has averaged about 65 in number, excluding consultants. The larger number of individuals listed below reflects a degree of turnover as the study moved through different phases. Excluded from the list are a number of part-time or intermittent personnel.]

Executive staff

Milton H. Cohen, Director, Ralph S. Saul, Associate Director, Richard H. Paul, Chief Counsel, Sidney M. Robbins, Chief Economist, and Herbert G. Schick, Assistant Director.

Professional staff

Supervisory staff: Robert L. Knauss, Robert N. Leavell, Martin Moskowitz, Frederick Moss, Norman S. Poser, Eugene H. Rotberg, Arthur J. Rothkopf, and David Silver. Special editorial assistant: Roy A. Schotland. Attorneys: James E. Bacon, Robert J. Birnbaum, James V. Hallisey, William C. Mammarella, Richard M. Meyer, Allan S. Mostoff, Lawrence W. Newman, Stephen J. Paradise, Ira H. Pearce, Sheldon Rappaport, Stanley Sporkin, Gary J. Strum, and C. Howard Thomas, Jr. Economists and statisticians: Leslie P. Anderson, Rolf Kaltenborn, Jonathan V. Levin, Helen K. Steiner, and Robert D. Tucker. Financial analysts: Harry Krueger, Bruce J. Simpson, Stuart R. Allen, Fred Siesel, Charles C. Sharpe, and Lois E. Zazove. Investigators: Carmine L. Asselta, John E. Connor, Fred E. Richard, Daniel J. Schatz, and Harry Zimmerman.

Clerical and secretarial staff

Administrative assistant: Juanita L. Ward. Clerical staff: Charles M. Atwell, Ann Hebert, Margaret C. Hull, M. Karen O'Heir Patten, Toby Orenstein, Jeannine A. Replogle, Richard G. Schwartz, Ethel L. Shiro, Gerald C. Spencer, Irma L. Weidowke, Susan G. Wendeburg, and W. Thomas Shepard. Secretarial staff: Ivadel E. Scarborough, Secretary to the Director, S. Marie Kemet, Secretary to the Associate Director, Rhoda S. Pines, Secretary to the Chief Counsel, Leah Ann Hare, Rebecca S. Klein, Dolores J. Lella, Catherine M. McDaniel, W. Loretta McEnroy, Mildred L. Reid, Elsie M. Rule, Betty J. Snead, Helen G. Wallick, Marie G. Waterman, and Pauline Zinkle.

Mr. STAGGERS. Mr. Chairman, in our agreement we stipulated that you would, perhaps, have Mr. Cohen make some remarks, and I just wondered if he could condense those, because the committee does have another hearing in this room. Kindly make them as brief as possible. We are going to have to return within a short time, and we won't get into any more questions.

Mr. HARRIS. Off the record.

(Discussion off the record.)

Mr. STAGGERS. All right, Mr. Cohen.

Mr. MILTON COHEN. Well, I will be very brief, Mr. Chairman.

I would merely say that the total report will be a big one, as this sample indicates. I figure that this will amount to about 40 percent of the total report, and since this runs about 1,500 typewritten pages with its tables and appendixes, and so on, that means a total report of around 4,000 pages.

The parts of it that are not yet complete are close to completion, and we say in our transmittal letter to the Commission which was part of the bundle that has been delivered here, that we anticipate completion of the entire report by about the end of May.

We outline in our transmittal letter to the Commission at pages 2 and 3 the main subject matters of those remaining chapters, so that you will have from this submission now a general picture of the total scope of the report.

The chapters that we are now submitting here deal with, first, a very general introduction in chapter I of the nature of the study and general data about the securities markets as a background for the substantive chapters.

In chapter II we get into the all-important, I think, question of the qualifications of people entering the business.

In chapter III, which is one of those now transmitted, we get into some of the important aspects of the broker dealer's relations with his customers; and in chapter IV we deal generally with the problem of distributions.

In chapter IX, which is also transmitted, we go into again a fundamental question of corporate disclosures and the differences in the requirements between listed securities and unlisted, which is rather fundamental to a good many of the other subjects discussed in the report. That is one reason why we wanted to have it transmitted at this time.

Chapters V, VI, VII, and VIII will deal with the trading markets, the exchanges, the over the counter, and various aspects of interrelationship among markets. Chapter X will deal with security credit. XI will deal with limited aspects of mutual funds. XII will deal with the self-regulatory institutions. We come back to the stock exchanges now as regulatory groups, and also the NASD and their role in the regulatory pattern.

In chapter XIII we will deal with the market break of May 1962 as to which we made a separate inquiry.

So that gives you the total picture. I was going to go on to some of the detailed conclusions of the present chapter, but I imagine that you would just as soon let that go for later.

Mr. STAGGERS. I think what you have told us has been very comprehensive. This report will give us something to digest, and we need time to digest it. We will have you return at your convenience. We will notify you.

I think that Mr. Dingell has a question he would like to ask.

Mr. DINGELL. Mr. Chairman, I will reserve my further questions until a later time. Mr. Cary, you have been most helpful, and it is always a pleasure to have you before the committee.

Mr. CARY. Thank you very much.

Mr. STAGGERS. I, too, as Chairman Harris said, compliment you on the manner in which this has been done. It was a very large job that was undertaken and you, too, Mr. Cohen, and there will be quite extensive questions later on.

As I say, as soon as you make the recommendations we will hold hearings with the facets of legislation then that you recommend, and which we shall gather from the public and others interested at the time. Thank you very kindly.

Mr. CARY. Thank you very much, sir.

(Whereupon, at 2:40 p.m., the subcommittee adjourned, subject to the call of the Chair.)

INVESTOR PROTECTION

TUESDAY, NOVEMBER 19, 1963

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE
OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to call, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The subcommittee will come to order.

This morning the Subcommittee on Commerce and Finance is reconvening to hear further from the Securities and Exchange Commission on the results of its Special Study on Securities Markets and its recommendations respecting such study, including recommendations for legislation.

The House Committee on Interstate and Foreign Commerce has ever been mindful of its duties to the Congress and to the public in seeing to it that the public has the protection which it has every right to believe that the securities statutes on the books are there to provide.

It was for this reason that I stated at our hearings on April 3 that this subcommittee initiated, the entire committee fully endorsed, and the Congress in 1961 enacted into law House Joint Resolution 438.

This law, Public Law 87–196, amended the Securities Exchange Act of 1934 to authorize and direct the Securities and Exchange Commission to make a study and investigation into the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade. The Commission was to report to the Congress by January 3, 1963, a date later extended to April 3, 1963.

It seems to me appropriate that we include in the record at this point a copy of Public Law 87–196.

(Public Law 87–196 follows:)

Public Law 87–196

87th Congress, H.J. Res. 438

September 5, 1961

JOINT RESOLUTION To amend the Securities Exchange Act of 1934 so as to authorize and direct the Securities and Exchange Commission to conduct a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That section 19 of the Securities Exchange Act of 1934 is amended by adding at the end thereof a new subsection as follows:

"(d) The Commission is authorized and directed to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade. The Commission shall report to the Congress on or before January 3, 1963, the results of its study and investigation, together with its recommendations, including such recommendations for legislation as it deems advisable. The Commission is authorized to appoint, without regard to the civil service laws, rules, and regulations, such personnel as the Commission deems advisable to carry out such study and investigation and to fix their respective rates of compensation without regard to the Classification Act of 1949, as amended, but no such rate shall exceed $18,500 per annum. To carry out such study and investigation there is hereby authorized to be appropriated the sum of $750,000."

Approved September 5, 1961.

Mr. STAGGERS. Last April 3 the Commission submitted to the Congress the first segment of a report prepared by its Special Study Group, created to carry out the study called for by this act. On July 17, the Commission submitted the second segment, and on August 8 submitted the final segment of the Special Study Group's report.

The 13-chapter Study Group report, which is printed in 4 parts as House Document 95, 88th Congress, and a fifth part comprising a summary of the Study Group conclusions and recommendations of the preceding 4 parts, is a monumental work, and this subcommittee and the committee, I am sure, are fully appreciative of the effort which went into providing this comprehensive analysis of our securities markets as they exist today.

I think it well, however, so that the record here may be complete, to include a brief recital of certain events since the subcommittee held its brief hearings on April 3 on the first segment of the Commission's study report. This consisted of part 1, comprising chapters I through IV, and of part 3, comprising chapter IX.

In hearings at that time, Chairman Cary outlined briefly some of the Commission's thinking concerning the Study Group recommendations, and Mr. Milton Cohen, Director of the Study Group, presented a summary of what was contained in the segment then filed, as well as an outline of what would be contained in the remaining Study Group reports.

It developed that, although Chairman Cary characterized the Study Group report as a responsible document, the subcommittee at that time chiefly was receiving the recommendations of the Study Group and not those of the Commission itself, as called for by Public Law 87–196. This law directed the Commission to report to the Congress on the results of the Commission study and investigation together with the Commission's recommendations for legislation, including such recommendations for legislation as the Commission deemed desirable.

On April 5, Chairman Harris wrote to Chairman Cary, requesting that with respect to each of the recommendations of the Study Group outlined to the subcommittee in its hearing on April 3, the Commission indicate (1) which the Commission had adopted as its own; (2) which the Commission had designated as the subject of the Commission's rulemaking process; and (3) which the Commission was holding in abeyance for further consideration or rejection.

On April 19, Chairman Cary replied in detail and gave a very helpful and explicit statement concerning the Commission's position on the first two volumes of the Study Group report.

Again, on July 17, the Commission transmitted to the Congress the second installment of the Study Group report which has appeared as part 2 and comprises chapters V through VIII. On July 23, Chairman Cary again wrote to Chairman Harris outlining the Commission position with respect to each of the Study Group's recommendations.

On July 26, Chairman Harris acknowledged the helpfulness of rereiving the Commission's position with respect to the Study Group's recommendations as well as the Commission's recommendations for additional legislation beyond those contained in the Commission's statement of its position on April 19. Mr. Harris expressed his concern over the fact that this second part did not yet contain the results of the Commission's study or recommendations on the highly important subject of the operation of the principle of self-regulation in the securities markets. He referred to the fact that the Securities and Exchange Act of 1934 is premised to a large degree upon the policy that both the exchange and over-the-counter markets should be substantially self-governed by certain rules for the protection of the public in the conduct of their operations, and that the reexamination of this policy was a primary objective of the committee and of the Congress in enacting Public Law 87–196.

Mr. Harris expressed the hope that when the committee had seen the whole study on the rules of both the national securities exchanges and the national securities associations, and what the Commission proposed to do about the rules governing the exchanges and the national securities associations either by legislation, by Commission rule, or by both, the committee would be enabled promptly to discharge its own legislative responsibility in the field.

The Study Group report on self-regulation, as well as the committee's position with respect to the Study Group report, was made to the Congress on August 8, but only recently has become available from the printer. This committee thereupon has moved with dispatch in discharging its responsibilities in this field.

I think for the record that we should insert at this point copies of the Commission's position with respect to the Study Group recommendations contained in Chairman Cary's letters of April 19, July 23, and August 8. Only the position of August 8 is contained in the part 5 summary of the Special Study, although it had been my understanding that the Commission's position with respect to chapters I through IX also would be included in such summary. In addition, I think it appropriate to include the letters of April 5 and July 26 from Chairman Harris to Chairman Cary.

(The documents referred to follow:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., April 5, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR CHAIRMAN CARY: I am sure that you appreciate that our committee cannot but be impressed with the manner in which you have undertaken the assignment which the Congress placed upon you nearly 2 years ago to undertake a study of the adequacy, for the protection of investors, of the rules of national securities

exchanges and national securities associations. Your presentation to the Subcommittee on Commerce and Finance, Wednesday afternoon, was helpful in an understanding of the magnitude of the task and of the nature of the reports which you are furnishing to the Congress.

I think it appropriate that you furnish the Congress with the results of the study and investigation as carried on by your Special Study Group inasmuch as any study of the character such as is this necessarily involves a consideration of the role which the Commission itself has played during the years being examined. On the other hand, the resolution does direct the Commission itself to report on its own recommendations to the Congress and the record in this specific regard seems a bit ambiguous.

I note that in the five chapters prepared by the Special Study Group which you have submitted as the first segment of your complete report each has a summary section containing conclusions and recommendations of the Study Group. In some chapters this appears at the end of the chapter whereas in others this summary is under different sections of the chapter. (It is understood that when you have completed all of the chapters, you have the thought of pulling together these summaries of conclusions and recommendations into one volume.)

It appears to me, accordingly, in the light of the language of section 19(d) and of the discussion before the Subcommittee last Wednesday, that it might be appropriate for you to indicate to us as to each of these recommendations which:

(1) You have adopted as your own and set forth in your transmittal letter;

(2) You have designated as the subject of the Commission's rulemaking process (as you indicated Wednesday you had initiated through letters addressed to industry representatives requesting them to create advisory committees for such consideration); and

(3) You are holding in abeyance for further consideration as to treatment in either of the ways above or possible rejection in their entirety.

Sincerely yours,

OREN HARRIS,
Member of Congress, Chairman.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 19, 1963.

HON. OREN HARRIS,
House of Representatives,
Washington, D.C.

DEAR MR. HARRIS: I appreciate your letter of April 5 and your generous comments with respect to the Report of the Special Study of Securities Markets—the first segment of which we submitted to you on April 3. You point out that Public Law 87–196 directs the Commission itself to report to the Congress on its own recommendations, and it might be appropriate for the Commission to indicate its views as to the specific recommendations already made by the Special Study.

May I say first of all that we stand strongly behind the report of the Special Study, as indicated in our letter of transmittal. With some reservations as to part D of chapter III and parts B and C of chapter IV—which we are holding in abeyance—we accept all the general recommendations made in the chapters of the Special Study which were submitted to you (chs. I–IV and IX). We are exceedingly fortunate to have assembled such a superlative group from private law practice, the universities, and the Commission staff to conduct this study. The report will be the most comprehensive of its kind in over 25 years and should be the keystone for regulatory and industry action.

The major objective of our letter of transmittal was to emphasize the legislative proposals and to report to Congress the principal ones which we hope to submit at the earliest possible time. We are keenly aware of your admonition to have these presented promptly, and further believe them to be an essential ingredient of investor protection and a prerequisite for further action, including rulemaking. Accordingly, we are now concentrating our efforts on drafting detailed statutory proposals and explanatory materials. At the same time, we shall over the next 6 weeks devote our attention to examining the balance of the report which has been promised by the end of May. For these reasons we are not yet focusing upon the exercise of rulemaking power, which is involved in numerous areas covered by the report.

After the legislation has been considered and the whole report submitted, we shall direct our attention to the rules recommended by the Special Study—which require appropriate submission to the public under the Administrative Procedure Act—and to other recommendations which will necessitate joint efforts with the industry. In certains areas, of course, we cannot provide immediate answers. As the Special Study's letter of transmittal to the Commission indicates, it would be impossible for the Special Study (or for the Commission) to propose "complete or final" answers to all the questions which they have posed. Indeed, "for some of the most knotty there is merely an indication of the possible approaches * * * that may point the way to future solutions."

As you will note, many of these recommendations consist of a statement of an objective to be attained, together with suggestions as to possible methods of accomplishing it, either by rules or policies of the Commission or by rules or policies of self-regulatory agencies. As the report of the Special Study recognizes, there are many instances where further exploration of alternatives is necessary to select the best method of accomplishing a specified end, and it may be that the method ultimately selected may differ to some extent from that recommended by the Special Study.

Moving now to the specific suggestion in your letter, we shall attempt to indicate as to each of the recommendations of the study those which we have adopted as appropriate for legislation, those we have designated as the subject of Commission rulemaking process, and those we shall hold in abeyance for further consideration (whether legislative or rulemaking).

CHAPTER II. QUALIFICATION OF PERSONS IN THE SECURITIES INDUSTRY

We are in agreement with all 12 conclusions and recommendations. They are an attempt to develop standards of character, competence, and financial responsibility and are the basis of legislative proposals, with three exceptions (items 3, 11, and 12) which can be handled under our rulemaking authority. With respect to items 11 and 12 relating to net capital requirements, the Commission will also provide in the legislative proposals that the self-regulatory organizations may have the same power with respect to financial responsibility as they would have with respect to character and competence.

CHAPTER III, PART B. SELLING PRACTICES

We are in agreement with all seven conclusions and recommendations. Only item 7 involves a legislative proposal, which was included in our letter of transmittal. This would provide the Commission with more flexible sanctions and the power to focus disciplinary action upon individual salesmen and branches.

Many of the recommendations in III, B are of a general nature which will require continuous development, achieved in large part through discussion with the industry, through action of the self-regulatory agencies, and in some particulars through the exercise of rulemaking power. The improvements suggested relate to supervision over selling practices, development in surveillance and enforcement procedures and in existing concepts of suitability, availability of information to customers, and modes of compensating salesmen.

Item 3 of the recommendations involving selling practices falls most clearly within our rulemaking power and would require designation of retail transactions as solicited or unsolicited, filing of customer complaints, and information as to the investment goals of the customer.

CHAPTER III, PART C. RESEARCH AND INVESTMENT ADVICE

We are in agreement with all five recommendations and conclusions. The fifth is a legislative proposal, i.e., that registered investment advisers other than broker dealers should be organized into an official self-regulatory association. We are still exploring the way in which it can best be achieved.

Items 2 and 4 in our opinion can be handled by rule. Item 2, relating to the content of market letters and investment advisory materials, would require disclosures of sources of information, research tecnhiques, existing positions in stocks recommended, persons responsible for the preparation of market letters, and other matters. Item 4 in effect would prohibit reckless dissemination of written investment advice.

The other conclusions and recommendations (items 1 and 3), generally discouraging indiscriminate advertising of research and advisory facilities, and recommending the strengthening of market letter surveillance, are directed to the self-regulatory agencies. We shall make every effort to foster action on their part.

CHAPTER III, PART D. PROTECTION OF CUSTOMERS' FUNDS AND SECURITIES

We accept the underlying principles, but wish to hold in abeyance the last four of the five conclusions and recommendations. The first, suggesting a reserve in cash or Government bonds of some part of the free credit balances, can be carried out under our rulemaking authority. Some additional time and attention, however, will have to be devoted to the exact mode of carrying it out. Items 2, 3, and 5 are interrelated proposals and technical in nature. We would prefer to bring them to Congress at a later date. Item 4 calls for further study.

CHAPTER III, PART E. DELIVERY OF SECURITIES

We agree with the four conclusions and recommendations, which are addressed in large part to the industry and self-regulatory institutions. We shall lend our support in seeing that they are carefully considered.

CHAPTER III, PART F. THE BROKER DEALER AS CORPORATE DIRECTOR

This is a general rather than a specific recommendation which we and the self-regulatory organizations should pursue.

CHAPTER IV. PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC. PART B. NEW ISSUES

We are generally in agreement with most of the conclusions and recommendations, but wish to hold in abeyance, for further study, parts of items 2 and 3. The first item is a general conclusion rather than a recommendation and we accept it as a preamble to the recommendations which follow.

The second is a series of proposals for rulemaking which are intended to eliminate or temper certain factors which contributed to the "hot issue" market of 1961 and early 1962. We feel that subrecommendations (a) and (b) relating to allotments of securities can and should be adopted but believe the balance; i.e., (c), (d), and (e) warrant further consideration. The third item (conditioning acceleration upon delivery of a prospectus or offering circular in substantially final form to any recipient of an original allotment 2 days before sales are made) raises a considerable number of problems and hence falls within the group held in abeyance.

We agree with the fourth item extending the requirement of delivery of prospectuses from 40 to 90 days in the case of new issues and have incorporated this within our lgislative proposals for registered securities. We believe the same principle can be applied to regulation A offerings by rule.

As to the fifth item, we agree with the conclusion that the NASD should strengthen its enforcement of the prohibition against free-riding and withholding, but the mechanics of achieving this will have to be considered further.

With respect to items 6 (review of underwriting arrangements) and 7 (relating to options, warrants or "cheap stock" in public offerings), we are in full agreement and shall take such action as is required by us and sponsor appropriate action by the NASD.

We agree with item 8 that the Commission should take appropriate steps to clarify the application of rule 10(b)(6) and shall take the necessary action.

CHAPTER IV, PART C. UNREGISTERED DISTRIBUTIONS

This part has three recommendations. We accept in principle the concept of notifying the Commission of these types of distributions for the purposes of information and enforcement. However, with respect to both the balance of the first recommendation and also the second one, we are inclined to hold them in abeyance for further consideration.

The third item is merely a reference back to earlier material in part C on which we have already expressed agreement.

CHAPTER IV. PART D. THE INTRASTATE EXEMPTION

We agree with the objective. The proposal to have advance notice of offerings filed with the Commission has been achieved in part by a recent rule of the NASD requiring a similar notification from its members. We shall hold in abeyance any decision as to how much further we should go beyond the action which the NASD has taken.

CHAPTER IV, PART E. REAL ESTATE SECURITIES

We have already adopted the recommendation that all distributors of and dealers in securities (including real estate securities) should be required to be members of a registered securities association. As previously noted, we are proposing legislation along those lines. The second item is a suggestion for further study of the problems in this field—which have been a continuing object of our consideration.

CHAPTER IV, PART F. INTEGRATION WITH PREVIOUS FILINGS

The integration of disclosure requirements under the Securities Act and the Exchange Act is a long-term program and warrants serious thought, but the final objective can only be achieved in gradual steps. Some time ago we instituted a short-form registration statement with respect to debt securities (S–9) and we shall now undertake a second step, the preparation of a comparable short form for certain equity securities on the basis discussed in the first conclusion and recommendation.

In connection with the first two paragraphs of the second item, we have been reevaluating the scope and content of our present reporting and proxy requirements and of our examining procedures.

We concur with the last paragraph of the second item that the waiting period for short-form filings should be kept to a minimum and have put this into effect. We are also seeking legislative authority to reduce in our discretion the time period during which dealers are required to deliver prospectuses.

CHAPTER IX. OBLIGATIONS OF ISSUERS OF PUBLICLY HELD SECURITIES. PART B. PROTECTIONS FOR INVESTORS IN LISTED AND UNLISTED SECURITIES

Chapter IX relates to extension of disclosure through reporting requirements and proxy statements and of the insider trading provisions to a larger number of companies—whose securities are traded over the counter. There are eight recommendations in part B. We have adopted them all but one and have embodied them in our legislative proposals wherever necessary. We shall hold in abeyance item 7(c), amending section 16(b). In addition to the recommendation of the Special Study, we shall offer these related proposals: first, authorizing the Commission to suspend trading of an over the counter security; second, requiring the filing of material contracts upon the registration of a security; and third, obligating a company to distribute to its stockholders information similar to proxy material where proxies have not been solicited.

Item 8 is a general approach with which we agree, and we shall explore the economic and technical problems involving the feasibility of increasing dissemination and use of filed information.

CHAPTER IX, PART C. CORPORATE PUBLICITY AND PUBLIC RELATIONS

There are three recommendations in part C. They meet with our general agreement. Item 1 recommends that stock exchanges and the NASD should establish high standards for the dissemination of corporate publicity, and we shall take steps to encourage this proposal. Based upon the recommendation in item 2, we shall propose a statute designed to prohibit false and misleading corporate publicity. We did not include this in our letter of transmittal because our views had not yet crystallized.

Item 3 concerning the disclosure of compensation paid to public relation counselors or firms meets with our full accord and is within our rulemaking power.

I believe this makes explicit our views with respect to all the recommendations made by the Special Study to date. As we indicated in the initial paragraphs of this letter, we are proceeding now with our legislative proposals and shall subsequently consider the exercise of our rulemaking authority. It should be

recognized that many of the recommendations of the Special Study were directed at encouraging action on the part of the self-regulatory institutions. Although in full accord, we would point out that at the present time our statutory powers to achieve these improvements are limited. Much, of course, can be carried out on the initiative of the exchanges and the NASD, but it is our belief that as a program of self-regulation is fostered and expanded, correspondingly broader powers of oversight are needed.

Although we have not had the benefit of the final conclusions of the Special Study on the role of self-regulatory institutions, the chapters already submitted inevitably call for their increased participation in the regulatory system. At the same time it has become clear that our power to alter and supplement the rules of the NASD is more limited than our power in connection with the exchanges. This unevenness is unwarranted, particularly in the light of the NASD's growing responsibilities. Accordingly, we are proposing as part of our legislative program some limited extension of oversight over the NASD so that it may be available if the public interest should require.

A copy of this letter is being sent to the chairman of the Senate Banking and Currency Committee.

Faithfully yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 23, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: As you are aware, on July 17, 1963, the Commission transmitted to the Congress the second installment of the Report of the Special Study of Securities Markets. In our letter of transmittal we indicated that we would shortly submit a more detailed response to the recommendations of the Special Study and that is the function of this letter. We recognize that the Congress expects such a response as evidenced by a letter from you, dated April 5, 1963, requesting our views with respect to the specific recommendations contained in the first part of the report.

We noted in our transmittal letter that we accept this report as a responsible springboard for rulemaking proposals and discussions with the industry. We further emphasized certain considerations serving as a background to any detailed responses by us to the recommendations, which we repeat here.

First, the second installment of the report contains recommendations designed to be carried out by the Commission under its rulemaking power and by the self-regulatory agencies. Accordingly, it is inappropriate for us to speak definitively on various of the questions presented which involve substantive changes in our rules and the rules of the self-regulatory agencies. In most cases we are required to solicit and consider the views of interested persons before making any final decisions. Moreover, we believe that the responsible course of action calls for discussions with the securities industry before definitive actions are taken. In the second place, we note the problems disclosed in the report are sublte and complex; many are just emerging and many call for further study. Finally, we point out that, although our legislative program—embodied in H.R. 6789, 6793, and S. 1642—is part of a general effort to raise standards in the securities markets, the program stands by itself; thus, consideration of the bills can appropriately proceed independently of the discusison and resolution of the questions raised in the chapters just transmitted.

With these considerations in mind, we turn to the specific recommendations. As we did in our letter of April 19, 1963, in answer to your request with regard to the first part of the report, we shall note those recommendations we have adopted as appropriate for legislation (only one), those we have designated as the subject of rulemaking, and those we shall hold in abeyance for further consideration (whether legislation or rulemaking). We would repeat here what we stated in that letter; namely, that many of the recommendations consist of a statement of objectives to be attained, together with suggestions as to possible ways of achieving them, either by rules or policies of the Commission, or of the self-regulatory agencies. It may be that the method ultimately selected will differ from that recommended by the study.

Chapter V is introduced and contains no recommendations.

CHAPTER VI. EXCHANGE MARKETS

Parts A through C are introductory.

Part D. Specialists

Item 1 is introductory to the remaining recommendations and indicates their applicability primarily to the New York and Amercan Stock Exchanges. With respect to items 2 and 3, we agree that a Commission rule concerning the dealer functions of specialists should be considered which would define, on the one hand, responsibilities and on the other restrictions upon trading. With respect to item 4, we agree with the need for higher capital requirements for specialists on the New York Stock Exchange. We also concur with item 5 which calls upon the exchanges to refine the obligations of specialists generally treated in items 2 and 3.

With respect to item 6, we accept the principle that all securities in which a specialist is registered should be maintaned in a single trading account.

With respect to item 7, we agree that the exchanges should undertake steps to refine the obligations of specialists as brokers and clarify various related floor procedures. As to item 7(f), we agree that specialists should be prohibited from servicing public customers. We believe that the Commission and the exchanges should consider whether the association of a specialist with a firm having public customers calls for remedial action.

We agree with item 8, calling for further reports by specialists and recommending that they be made public. As to item 9, we accept the recommendation for further studies relating to the capacity of specialists to acquire larger blocks of stock. We agree with item 10 which calls for further protections and certain reports respecting the financial position of specialists. We also agree that additional surveillance techniques regarding specialist performance should be developed in accordance with the recommendations contained in item 11.

E. Odd-lot dealers

We agree with the recommendations of the Special Study relating to odd-lot activities.

F. Floor traders

As to item 1, in light of the very serious and basic problems presented by the continuation of floor trading, as brought out by the report of the Special Study and as evidenced by prior studies, and of the lengthy and apparently unsuccessful efforts to resolve them, the Commission agrees that a rule proposal abolishing floor trading on the New York and American Stock Exchanges should be developed, unless those exchanges demonstrate that its continuance would be consistent with the public interest.

We believe studies on the possibility of "auxiliary specialists" should be undertaken as suggested in item 2.

We accept the recommendation in item 3 that separate consideration should be given to the problem of floor trading on the regional exchanges.

G. Members' off-floor trading

We agree with the one item in this part.

H. Short selling

We concur with item 1 that more refined and complete information as to short selling transactions is needed, and with item 2 recommending a reexamination of procedures with respect to the reporting of "short-exempt" transactions. In respect of item 3, we agree that there is a need for a rule of broader perspective to provide a more effective regulatory control over short selling in a security when its market is under selling pressure.

I. Commission rates

With respect to item 1, the Commission agrees that it should address more positive and continuous attention to the commission rate structure of the New York Stock Exchange. We accept the suggestions that studies should be made concerning: arrangements for discounts for nonmember broker-dealers (item 2); volume discounts (item 3); and the feasibility and desirability of separate schedules for the brokerage and service components of commission rates (item 4).

As to items 5 and 6, the Commission recognizes that the problems involved in regulating commission rates in the securities business are far more intricate and intangible than those involved in public utility rate regulation, but that it would

be desirable, to the extent possible, that the Commission's role in the ratefixing process be more clearly articulated. The Commission agrees that the development of additional data and allocation formulas will also facilitate determination of the extent to which the establishment of objective standards for measuring the reasonableness of commission rates is feasible and useful.

With regard to item 7, the Commission will consider the adequacy of its arrangements with the New York Stock Exchange—developed at the time of the last commission rate increase in 1958—for supplying advance notice and information with respect to proposed increases.

We agree with the recommendation contained in item 8 regarding separate disclosure of the odd-lot differential and the brokerage commission in confirmations of odd-lot transactions.

J. Automation—Its needs and possibilities

With respect to the items in this section, the Commission agrees that the impact of automation on its operations and on the operations of the exchanges and of the member firms should be the subject of continuing study.

CHAPTER VII. OVER-THE-COUNTER MARKET

The study has presented a series of conclusions and recommendations with respect to the over-the-counter market. One of these, relating to establishing appropriate controls over quotations systems, would require legislative action (item 1). We have already indicated our agreement that an amendment to the Exchange Act should be developed to achieve this purpose. It is believed that substantially all of the remaining items could be the subject of rulemaking by the Commission or the National Association of Securities Dealers.

The Commission agrees that a number of the practices discussed in this chapter appear inimical to the public interest and require additional or better controls, and that these matters should be considered promptly by the NASD and the Commission in terms of seeking effective corrective measures. Among these are included such items as the integrity of wholesale quotations (item 2, 3(a), and 3(b)); the development and dissemination of rules or policy directives relating to the obligations of broker-dealers to exercise diligence in seeking "best executions" of customers' orders (item 6); the formulation of rules or guides governing the proper methods to be followed, disclosures to be made, and the fairness of rates charged in the execution of various types of so-called "riskless transactions" (item 7); and the clarification, refinement, and fostering of better understanding of the NASD markup policy as it should be applied in various situations, giving appropriate recognition to the varying problems and policies applicable to broker-dealers performing differing roles in the wholesale and retail markets (item 8).

The Commission agrees also that it would be desirable for the NASD to continue its efforts to improve and strengthen its methods of handling "local quotations" and to endeavor to improve the information content of its retail-quotations system along the lines indicated in items 10, 11, and 12. From a longer range point of view, as proposed in item 14, it is of course essential that developments in automation be understood and its potential for improving the flow of information about the over-the-counter market be recognized and appropriately applied. As to item 15, we are prepared to consider with the NASD the feasibility of establishing a reporting system. We shall take into account the effect of any proposals on the third market (item 16). Finally we shall consider, with the NASD, the subjects raised in item 5.

The foregoing represent aspects of the over-the-counter markets as they have evolved and now exist which are among those pointed to by the Special Study as problem areas which call for reassessment by the NASD and the Commission. It is clear that proper solutions to these, together with action to be taken pursuant to recommendations in other chapters and enactment of the pending legislative proposals, should improve significantly, and promote better understanding of, the operation of the over-the-counter markets.

The remaining recommendations, namely, all or parts of items 3(c), 4, 9, and 13, call for exploration, study or action with respect to new regulatory concepts which could be expected to change, in some respects quite drastically, the existing methods for pricing securities in over-the-counter retail transactions and the operating procedures which have evolved in the conduct of that market. The Commission is not prepared, on the basis of the work so far done, to determine which of these concepts, if any, should replace those so far applied in the

discharge of our obligations under the act. Certainly, at this juncture, it would be impossible for the Commission to judge with assurance or certainty what the ultimate and total effect some of these suggestions might have upon the markets and the broad and essential functions they perform. We view these subjects as appropriate for discussions with our staff and with industry. Out of these, there may develop substantial changes, accelerated by the assistance of rapidly developing technology, in market procedures and in the quantity and dependability of information quickly available to the marketplace concerning the volume and prices of securities transactions in the over-the-counter market.

CHAPTER VIII. TRADING MARKETS—INTERRELATIONSHIPS

B. The basic allocation between exchanges and over-the-counter (as primary markets)

In respect of item 1, we agree that the listing and delisting standards of the exchanges should be reexamined.

We agree, as suggested by item 2, that a government-industry study of the feasibility and desirability of reducing the round-lot unit for all or some securities shoud be undertaken in the near future.

C. Institutional participation and block transactions

With regard to item 1, the Commission agrees that it is important to obtain an adequate body of information about institutional securities transactions on a continuous basis.

Item 2 is held in abeyance and subject to discussion with the Department of Labor which administers the Federal Welfare and Pension Plans Disclosure Act.

With respect to item 3, we agree that the trading practices of institutions should be taken into account in any study of the Commission rate structure, previously noted in connection with the recommendations in chapter VI, part I.

D. Over-the-counter markets in exchange-listed securities

With regard to item 1, the study has pointed out the increasing importance of the so-called third market and, upon the basis of the evidence before it, has concluded that, under existing circumstances, this market is on balance beneficial to the public interest. This conclusion calls for no action by the Commission. The Commission recognizes, however, that other recommendations of the study call upon it to undertake further studies and analyses, primarily relating to the Commission rate structure of the New York Stock Exchange, which may result in proposals which could alter the conditions under which the third market operates and in other ways have an impact upon it.

As to items 2, 3, 5, and 6, the Commission agrees that additional data concerning the third market is necessary on a continuous basis. The exact content and amount of this data will be determined after further review and consultation with the affected persons.

As to item 4, our comments on item 7 in chapter VII are equally applicable here.

E. Allocation among exchanges, the regional exchanges as primary and secondary markets

Item 1 represents an introductory approach to the problem of the regional exchanges with which we generally agree.

With respect to item 2, we agree that in any study of the Commission rate structure, previously noted in connection with the recommendations in chapter VI, part I, due regard should be given to the potential impact of any proposals on the regional exchanges.

We agree with the Study's conclusion in item 3 that the survival of regional exchanges as primary markets would appear to be in the public interest. The steps to be taken, and the methods by which these ends can be achieved, must be worked out in conjunction with the exchanges. In the course of considering these steps, the Commission and the exchanges can consider whether, and to what extent, the specific recommendations in items 4 and 5 can and should be carried out.

F. General considerations

With respect to items 1, 2, and 3, we agree that the accumulation and analysis of data with respect to the trading markets is desirable on a more continuous basis. We have already moved in this direction and have established an Office

of Program Planning to assist in such a program. The content and quantity of the required data will be determined in the light of the recommendations of our new Office and of our operating divisions, and after consultations with the industry.

I believe this makes explicit our views with respect to the recommendations made by the Special Study in the second installment of the report. We anticipate that the final installment of the report will be submitted to Congress in the near future.

This letter is also being sent to the chairman of the Senate Committee on Banking and Currency.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., July 26, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: I desire to acknowledge your letter of July 23, 1963, although you will appreciate that owing to the demands of our legislative schedule this week I have not been able to give the letter and its contents the attention which I am certain they merit.

Naturally, we are pleased to have the second installment of the Commission's recommendations including recommendations for legislation to add to those of your letter of April 19. I am sure that you appreciate that we have been somewhat disturbed, as I know you have been, over the delay in receiving the results of the Commission's study and of its recommendations although I well can understand that there may be problems of staff and time which have deterred you from meeting the original schedule. I feel that I must express my continuing concern over the fact that even this second part does not contain the results of the Commission's study nor the Commission's recommendations on the highly important subject of the operation of the principle of self-regulation in the securities markets, and I trust that as you have indicated, this further installment will be available in the near future.

The Securities Act of 1934, of course, is premised to a large degree upon the policy that both the exchange and over-the-counter markets should be substantially self-governed by certain rules for the protection of the public in the conduct of their operations. The reexamination of this policy with all of its ramifications was a primary objective of the committee and the Congress 2 years ago in adding section 19(d) to the act. This section directs the Commission to make a study of the adequacy, for the protection of investors, of the rules of the national securities exchanges and national securities association, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade.

It is my hope that when we see the whole study on the rules of both the exchanges and the national securities association, and see what the Commission proposes to do about the rules governing the exchanges and the national securities association either by legislation, by Commission rule, or by both, we shall be enabled promptly to discharge our own legislative responsibilities in the field.

This committee has ever been mindful of its duties to the public in seeing to it that the public has the protection which it has every right to believe the statutes provide. It was for this reason that we initiated the study and for this reason we shall give the study results and Commission recommendations full consideration. I know that you share with us this same desire to assure adequacy of protection for the investors, and, accordingly, we shall look forward to your completion of the assignment entrusted to you at as early a date as possible.

Sincerely yours,

OREN HARRIS, *Member of Congress.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 8, 1963.

The PRESIDENT OF THE SENATE.
The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

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.

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 rulemaking, 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 unrivaled 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.[1]

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, XII–E, and XII–F of the report.

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

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[1] As to the recommendations in item 2, we favor steps looking toward 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.

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 overreaching 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.

4

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 respects 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 nonmember, without any hearing afforded the nonmember, 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 toward 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 appendixes. 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 initial payments—up to 50 percent—taken out for sales load 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.[2]

[2] With respect to item 2, subch. 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 subch. 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.

As the Congress is aware, on August 27, 1962, the Commission transmitted to the Congress "A Study of Mutual Funds," representing a factfinding 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 sometime 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 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 1930's. 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.

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 rulemaking 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 reexamination. It has required a Special Study, detached from involvement with routine, but necessary, tasks, to produce a comprehensive, overall 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. Robins 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:

WILLIAM L. CARY, *Chairman.*

Mr. STAGGERS. So much for the background to date.

Today we are commencing our hearings by having Chairman Cary present to us an accounting of the Commission's stewardship of its responsibilities under Public Law 87–196 in investigating the adequacy for the protection of investors of the rules of national securities exchanges and national securities associations. These hearings will take up, as set out in section 19(d), the results of the committee's study and investigation and the Commission's recommendations, including the Commission's recommendations for legislation.

The Commission's recommendations for legislation are embodied in two bills, H.R. 6789, introduced by Chairman Harris, and an identical bill, H.R. 6793, introduced by myself. In addition, we have before us S. 1642, an amended version of the Commission's legislative recommendations as that version passed the Senate. I think it appropriate to include copies of these bills and the agency reports at this point in the record.

(The bills and reports referred to follow:)

[H. R. 6789, H. R. 6793, 88th Cong., 1st sess.]

A BILL To amend the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, to extend disclosure requirements to the issuers of additional publicly traded securities, to provide for improved qualification and disciplinary procedures for registered brokers and dealers, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Securities Acts Amendments of 1963".

SEC. 2. Section 3(a) of the Securities Exchange Act of 1934, as amended, is amended by adding at the end thereof the following four paragraphs:

"(18) The term 'person associated with a broker or dealer' means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly controlling or controlled by such broker or dealer, including any employee of such broker or dealer. The Commission may by rules and regulations classify, for the purpose of any portion or portions of this title, persons, including employees, controlled by a broker or a dealer. In such rules and regulations the Commission shall appropriately exclude from the scope of subsection (b) (other than paragraph (3) thereof) of section 15 hereof persons associated with a broker or dealer whose functions are clerical or ministerial.

"(19) The term 'investment company,' 'affiliated person,' and 'insurance company' have the same meanings as in the Investment Company Act of 1940.

"(20) The terms 'investment adviser' and 'underwriter' have the same meanings as in the Investment Advisers Act of 1940.

"(21) The term 'person associated with a member' means a person who is registered with a registered securities association pursuant to its rules or who is associated with a broker or dealer which is a member of such association."

SEC. 3. (a) Section 12(b) of said Act is amended as follows:

(1) Subparagraphs (I) through (K) of paragraph (1) are redesignated as (J) through (L), respectively.

(2) A new subparagraph (1)(I) is added to read as follows:

"(I) material contracts, not made in the ordinary course of business, which are to be executed in whole or in part at or after the filing of the

application or which were made not more than two years before such filing, and every material patent or contract for a material patent right shall be deemed a material contract."

(3) A new paragraph (3) is added to read as follows:

"(3) Such copies of material contracts, referred to in paragraph (1)(I) above, as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security."

(b) Section 12(f) of said Act is amended to read as follows:

"(f) Notwithstanding the foregoing provisions of this section, any national securities exchange, subject to the terms and conditions hereinafter set forth, (1) may continue unlisted trading privileges to which a security had been admitted on such exchange prior to the effective date of subsection (g) of section 12 of this title, or (2) upon application to and approval of such application by the Commission, may extend unlisted trading privileges to any security duly listed and registered on any other national securities exchange. If an extension of unlisted trading privileges to a security was originally based upon its listing and registration on another national securities exchange, such privileges shall continue in effect only so long as such securities shall remain listed and registered on any other national securities exchange.

"No application pursuant to this subsection shall be approved unless the Commission finds, after appropriate notice and opportunity for hearing, that the extension of unlisted trading privileges pursuant to such application is necessary or appropriate in the public interest or for the protection of investors.

"The Commission shall by rules and regulations suspend unlisted trading privileges in whole or in part for any or all classes of securities for a period not exceeding twelve months, if it deems such suspension necessary or appropriate in the public interest or for the protection of investors or to prevent evasion of the purposes of this title.

"On the application of the issuer of any security for which unlisted trading privileges on any exchange have been continued or extended pursuant to this subsection, or of any broker or dealer who makes or creates a market for such security, or of any other person having a bona fide interest in the question of termination or suspension of such unlisted trading privileges, or on its own motion, the Commission shall by order terminate, or suspend for a period not exceeding twelve months, such unlisted trading privileges for such security if the Commission finds, after appropriate notice and opportunity for hearing, that such termination or suspension is necessary or appropriate in the public interest or for the protection of investors.

"In any proceeding under this subsection in which appropriate notice and opportunity for hearing are required, notice of not less than ten days to the applicant in such proceeding, to the issuer of the security involved, to the exchange which is seeking to continue or extend or has continued or extended unlisted trading privileges for such security, and to the exchange, if any, on which such security is listed and registered, shall be deemed adequate notice, and any broker or dealer who makes or creates a market for such security, and any other person having a bona fide interest in such proceeding, shall upon application be entitled to be heard.

"Any security for which unlisted trading privileges are continued or extended pursuant to this subsection shall be deemed to be registered on a national securities exchange within the meaning of this title. The powers and duties of the Commission, under subsection (b) of section 19 of this title shall be applicable to the rules of an exchange in respect of any such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions, or for stated periods, exempt such securities from the operation of any provision of section 13, 14, or 16 of this title."

(c) Section 12 of said Act is further amended by adding thereto the following new subsection:

"(g)(1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall—

"(i) within one hundred and twenty days after the last day of its fiscal year ended after the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and

"(ii) within one hundred and twenty days after the last day of its fiscal year ended after two years from the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons

register such security by filing with the Commission a registration statement (and such duplicate originals as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to register a security pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 18 of this title. Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.

"(2) The provisions of this subsection shall not apply in respect of—

"(A) any security listed and registered on a national securities exchange;

"(B) any security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940;

"(C) any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawable capital, issued by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution;

"(D) any security of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual; or

"(E) any security of a foreign issuer, including any certificate of deposit for such a security, unless the Commission, by rules or regulations, or by order after notice and opportunity for hearing, on its own motion or upon application of an interested person, finds that a substantial public market for the equity securities of such issuer or of a class of issuers which includes such issuer exists in the United States and that continued exemption of securities of such issuer or class of issuers is not in the public interest or consistent with the protection of investors.

"(3) Registration of any class of security pursuant to this subsection shall be terminated ninety days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than three hundred persons. The Commission shall after notice and opportunity for hearing deny termination of registration if it finds that the certification is untrue. Termination of registration shall be deferred pending final determination on the question of denial.

"(4) For the purposes of this subsection the term 'class' shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may for the purpose of this subsection define by rules and regulations the terms 'total assets' and 'held of record' as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection."

(d) Section 12 of said Act is further amended by adding thereto the following new subsection:

"(h) The Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from the provisions of subsection (g) hereof or from sections 13, 14, or subsection 15(d) of this title or may exempt from section 16 hereof any officer, director, or beneficial owner of securities of any issuer, any security of which is required to be registered pursuant to subsection (g) hereof, upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities,

the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors. The Commission may, for the purposes of any of the above-mentioned sections or subsections of this title classify issuers and prescribe requirements appropriate for each such class."

(e) Section 12 of said Act is further amended by adding thereto the following new subsection:

"(i) In respect of any securities issued by banks the powers, functions, and duties of the Commission pursuant to the provisions of this title shall be delegated in whole or in part to the Federal banking regulatory agency or instrumentality which has jurisdiction to examine or supervise the business of such banks, upon the request of such agency or instrumentality."

SEC. 4. Section 13(a) of said Act is amended to read as follows:

"(a) Every issuer of a security registered pursuant to section 12 of this title shall file with the Commission the information, documents, and reports below specified (and such duplicate originals as the Commission may require) in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the securities—

"(1) Such information and documents as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 12.

"(2) Such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports, as the Commission may prescribe.

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange."

SEC. 5. (a) Section 14(a) of said Act is amended to read as follows:

"(a) It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title."

(b) Section 14(b) of said Act is amended to read as follows:

"(b) It shall be unlawful for any member of a national securities exchange, or any registered broker or dealer, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to give, or to refrain from giving a proxy, consent, or authorization in respect of any security registered pursuant to section 12 of this title and carried for the account of a customer."

(c) Section 14 of said Act is further amended by adding thereto the following new subsection:

"(c) Unless proxies, consents, or authorizations in respect of a security registered pursuant to section 12 of this title are solicited by or on behalf of the management of the issuer from the recordholders of such security in accordance with subsection (a) of this section and the rules and regulations thereunder, prior to any annual or other meeting of the holders of such security, such issuer shall, in accordance with rules and regulations prescribed by the Commission, file with the Commission and transmit to all recordholders of such security information substantially equivalent to the information which would be required to be transmitted if a solicitation were made."

SEC. 6. (a) Section 15(a) of said Act is amended to read as follows:

"(a) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than exempted security or commercial paper, banker's acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer (A) is registered in accordance with subsection (b) of this section, and (B) is a member of a securities association which is registered pursuant to section 15A of this title.

"The Commission may by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for specified

periods, exempt from clauses (A) and (B), or both, of this subsection (a) any broker or dealer or category of brokers or dealers specified in such rules, regulations, or orders. Clause (B) of this subsection (a) shall be inapplicable with respect to: (i) all brokers and dealers during any period in which there is no registered securities association, and (ii) any broker or dealer during any period in which the rules of each registered securities association preclude the membership therein of such broker or dealer solely because of the geographical location of, or type of business done by, such broker or dealer."

(b) Section 15(b) of said Act is amended to read as follows:

"(b)(1) A broker or dealer may be registered for the purposes of this section by filing with the Commission an application for registration, which shall contain such information in such detail as to such broker or dealer and any persons associated with such broker or dealer as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine.

"An application for registration of a broker or dealer to be formed or organized may be made by a broker or dealer to which the broker or dealer to be formed or organized is to be the successor. Such application shall contain such information in such detail as to the applicant and as to the successor and any person associated with the applicant or the successor, as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine. Such registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Commission may prescribe, adopt such application as its own.

"If any amendment to any application for registration pursuant to this subsection is filed prior to the effective date thereof, such amendment shall be deemed to have been filed simultaneously with and as part of such application; except that the Commission may, if it appears necessary or appropriate in the public interest or for the protection of investors, defer the effective date of any such registration as thus amended until the thirtieth day after the filing of such amendment.

"Any provision of this title (other than section 5 and subsection (a) of this section 15) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any broker or dealer registered pursuant to this subsection or any person acting on behalf of such a broker or dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

"(2) The Commission shall, after appropriate notice and opportunity for hearing, by order censure, deny registration to, suspend for a period not exceeding twelve months or revoke the registration of, any broker or dealer if it finds that such censure, denial, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, (A) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or (B) has been convicted within ten years preceding the filing of the application or at any time thereafter of any felony or misdemeanor which the Commission finds: (i) involves the purchase or sale of any security, (ii) arises out of the conduct of the business of a broker, dealer, or investment adviser, (iii) involves embezzlement, fraudulent conversion, or misappropriation of funds or securities, or (iv) involves the violation of section 1341, 1342, or 1343 of title 18, United States Code, as heretofore or hereafter amended; or (C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee

of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security; or (D) has willfully violated any provision of the Securities Act of 1933, or of the Investment Advisers Act of 1940, or of the Investment Company Act of 1940, or of this title, as any of such statutes heretofore have been or hereafter may be amended, or of any rule or regulation under any of such statutes; or (E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Investment Advisers Act of 1940, or the Investment Company Act of 1940, or of this title, as any such statutes heretofore have been or hereafter may be amended, or of any rule or regulation under any of such statutes or has failed reasonably to supervise, with a view to preventing violations of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision; or (F) is subject to an order of the Commission entered pursuant to paragraph (3) of this subsection (b) barring or suspending the right of such person to be associated with a broker or dealer, which order is in effect with respect to such person. For the purposes of clause (E) of this paragraph, no person shall be deemed to have failed reasonably to supervise any person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person; and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with. Pending final determination whether any such registration shall be denied, the Commission may by order postpone the effective date of such registration for a period not to exceed fifteen days, but if, after appropriate notice and opportunity for hearing (which may consist solely of affidavits and oral arguments), it shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors to postpone the effective date of such registration until final determination, the Commission shall order. Pending final determination whether any such registration shall be revoked, the Commission shall by order suspend such registration if, after appropriate notice and opportunity for hearing, such suspension shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors. Any registered broker or dealer may, upon such terms and conditions as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered broker or dealer, or any broker or dealer for whom an application for registration is pending, is no longer in existence or has ceased to do business as a broker or dealer, the Commission shall by order cancel the registration or application of such broker or dealer.

"(3) The Commission may, after appropriate notice and opportunity for hearing, by order censure any person or bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer, if the Commission finds that such censure, barring or suspension is in the public interest and that such person has committed or omitted any act or omission enumerated in clauses (A), (D), or (E) of paragraph (2) of this subsection (b) hereof or has been convicted of any offense specified in clause (B) of said paragraph (2) hereof or is enjoined from any action, conduct, or practice specified in clause (C) of said paragraph (2). It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with a broker-dealer is in effect, willfully to become, or to be, associated with a broker or dealer, without the consent of the Commission, and it shall be unlawful for any broker or dealer to permit such a person to become, or remain, a person associated with him, without the consent of the Commission, if such broker or dealer knew, or in the exercise of reasonable care, should have known, of such order."

(c) Section 15(c) of said Act is amended by adding at the end thereof the following new paragraphs:

"(4) If the Commission finds, after notice and opportunity for hearing, that any person subject to the provisions of sections 12, 13 or subsection (d) of section 15 of this title or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Com-

mission may publish its findings and issue an order requiring such person to comply with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.

"(5) If in its opinion the public interest and the protection of investors so require, the Commission is authorized summarily to suspend trading, otherwise than on a national securities exchange, in any security (other than an exempted security) for a period not exceeding ten days. No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in which trading is so suspended."

(d) Section 15(d) of said Act is amended to read as follows:

"(d) Each issuer which has filed a registration statement containing an undertaking which is or becomes operative under this subsection as heretofore in effect, and each issuer which shall hereafter file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title in respect of a security registered pursuant to section 12 of this title. The duty to file under this subsection shall be automatically suspended if and so long as (1) any issue of securities of such issuer is registered pursuant to section 12 of this title, or (2) the securities of each class to which the registration statement relates are held of record by less than three hundred persons at the end of its last fiscal year subsequent to the conclusion of the offering and immediately preceding the date on which such information, documents, and reports would otherwise be required to be filed. For the purposes of this subsection, the term 'class' shall be construed to include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. Nothing in this subsection shall apply to securities issued by a foreign government or political subdivision thereof."

SEC. 7. (a) Section 15A(b) of said Act is amended as follows:

(1) Paragraph (3) thereof is amended to read as follows:

"(3) the rules of the association provide that any broker or dealer who makes use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, may become a member of such association, except such as are excluded pursuant to paragraphs (4) and (5) of this subsection: *Provided*, That the rules of the association may restrict membership in such association on such specified geographical basis, or on such specified basis relating to the type of business done by its members, or on such other specified and appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purpose of this section; rules adopted by the association may provide that the association may, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, deny admission to or refuse to continue in such association any broker or dealer if (i) such broker or dealer, whether prior or subsequent to becoming such, or (ii) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, has been and is suspended or expelled from a national securities exchange or has been and is barred or suspended from being associated with all members of such exchange, for violation of any rule of such exchange;".

(2) Paragraph (4) thereof is amended to read as follows:

"(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued in membership in such association, if (i) such broker or dealer, whether prior or subsequent to becoming such, or (ii) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated (A) has been and is suspended or expelled from a registered securities association (whether national or affiliated) or from a national securities exchange or has been and is barred or suspended from being associated with all members of such association or

from being associated with all brokers or dealers which are members of such exchange, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade, or (B) is subject to an order of the Commission denying, suspending for a period not exceeding twelve months or revoking his registration pursuant to section 15 of this title, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or barring or suspending him from being associated with a broker or dealer, or (C) by his conduct while associated with a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such broker or dealer, and in entering such a suspension, expulsion or order, the Commission or any such exchange or association shall have jurisdiction to determine whether or not any person was a cause thereof;".

(3) Paragraphs (5) through (10) thereof are redesignated as paragraphs (6) through (11), respectively, and a new paragraph (5) is added to read as follows:

"(5) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such other qualifications of such person as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such member. For the purpose of defining such standards and the application thereof, such rules may (A) appropriately classify prospective members (taking into account relevant matters, including type of business done and nature of securities sold) and persons proposed to be associated with members, (B) specify that all or any portion of such standards shall be applicable to any such class, (C) require persons in any such class to pass examinations prescribed in accordance with such rules, (D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and such other qualifications as the association finds appropriate, (E) provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to the training, experience, financial responsibility, and other qualifications of the applicant and that the association may adopt procedures for verification of qualifications of the applicant, and (F) require any class of persons associated with a member to be registered with the association in accordance with procedures specified by such rules (and any application or document supplemental thereto required by such rules of a person seeking to be registered with such association shall, for the purposes of subsection (a) of section 32 of this title, be deemed an application required to be filed under this title)."

(4) Redesignated paragraph (9) is amended to read as follows:

"(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules;".

(5) Redesignated paragraph (14) is amended to read as follows:

"(10) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules shall require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include (A) a statement setting forth any act or practice in which such member or other person may be found to have

engaged, or which such member or other person may be found to have omitted, (B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation, (C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade, and (D) a statement setting forth the penalty imposed. In any proceeding to determine whether a broker or dealer shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the broker or dealer or person shall be notified of, and be given an opportunity to be heard upon the specific grounds for denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based; and".

(6) Section 15A(b) is further amended by adding two unnumbered paragraphs at the end thereof, to read as follows:

"The rules of the association shall include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be disseminated by any member or any person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations.

"*Provided, however*, That the rules of a registered securities association which was registered on the effective date of the amendments to this subsection (b) contained in Public Law Numbered — need not conform to the requirements of such subsection as so amended until 1964. After 1964, the Commission may, after notice and opportunity for hearing, suspend the registration of any such association if it finds that the rules do not conform to the requirements of this subsection (b) as so amended and any such suspension shall remain in effect until the Commission issues an order determining that such rules have been modified to conform with the requirements of this subsection (b) as so amended."

(b) Section 15A(d)(2) is amended by striking the figure "(9)" inserting in lieu thereof "(10)".

(c) Section 15A(g) is amended to read as follows:

"(g) If any registered securities association (whether national or affiliated) shall take any disciplinary action against any member thereof or any person associated with such a member or shall deny admission to any broker or dealer seeking membership therein, or shall bar any person from being associated with a member, such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall operate as a stay of such action until an order is issued upon such review pursuant to subsection (h), unless the Commission shall otherwise order, after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments)."

(d) Section 15A(h) is amended to read as follows:

"(h)(1) In a proceeding to review disciplinary action taken by a registered securities association against a member thereof or a person associated with a member, if the Commission, after appropriate notice and opportunity for hearing, upon consideration of the record before the association and such other evidence as it may deem relevant, shall (A) find that such member or person has engaged in such acts or practices, or has omitted such act, as the association has found him to have engaged in or omitted, and (B) shall determine that such acts or practices, or omission to act, are in violation of such rules of the association as have been designated in the determination of the association, the Commission shall by order dismiss the proceeding, unless it appears to the Commission that such action should be modified in accordance with paragraph (2) of this subsection. The Commission shall likewise determine whether the acts or practices prohibited, or the omission of any act required, by any such rule constitute conduct inconsistent with just and equitable principles of trade, and shall so declare. If it appears to the Commission that the evidence does

not warrant the finding required in clause (A) or if the Commission shall determine that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the association, or that such act as is found to have been omitted is not required by such designated rule or rules, the Commission shall by order set aside the action of the association.

"(2) If, after appropriate notice and opportunity for hearing, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

"(3) In any proceeding to review the denial of membership in a registered securities association or barring any person from being associated with a member, if the Commission, after appropriate notice and hearing, and upon consideration of the record before the association and such other evidence as it may deem relevant, shall determine that the specific grounds on which such denial or bar is based exist in fact and are valid under this section, the Commission shall by order dismiss the proceeding; otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant broker or dealer to membership therein, or to permit such person to be associated with a member."

(e) Section 15A(k)(2) is amended to read as follows:

"(2) The Commission may in writing request any registered securities association to adopt any specified alteration of or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modifications of such alteration or supplement as it deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section, with respect to: (A) The basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member of the disciplining of members or persons associated with members, or the qualifications required for members or persons associated with members or any class thereof; (B) the method for adoption of any change in or addition to the rules of the association; (C) the method of choosing officers and directors; and (D) affiliation between registered securities associations."

(f) Section 15A(1)(2) is amended to read as follows:

"(2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a registered securities association any member thereof, or to suspend for a period not exceeding twelve months or to bar any person from being associated with a member thereof, if the Commission finds that such member or person (A) has violated any provision of this title or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this title or any rule or regulation thereunder, or (B) has willfully violated any provision of the Securities Act of 1933, as amended, or of any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was willfully violating with respect to such transaction any provision of such Act or rule or regulation."

SEC. 8. (a) Section 16(a) of said Act is amended to read as follows:

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to subsection (g) of section 12 of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities

exchange, shall also file with the exchange) a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

(b) Section 16 of said Act is further amended by redesignating subsection (d) thereof as (e) and adding a new subsection (d) as follows:

"(d) The provisions of subsection (b) of this section shall not apply to any purchase and sale, or sale and purchase, and the provisions of subsection (c) of this section shall not apply to any sale, of an equity security not then or theretofore held by him in an investment account, by a broker or dealer in the ordinary course of his business and incident to the establishment or maintenance of a primary or secondary market for such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, define and prescribe terms and conditions with respect to securities held in an investment account and transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market."

SEC. 9. Section 20(c) of said Act is amended to read as follows:

"(c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this title or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information."

SEC. 10. Section 32 of said Act is amended by striking subsection (b) thereof and by redesignating subsection (c) thereof as "(b)".

SEC. 11. Section 4 of the Securities Act of 1933, as amended, is amended to read as follows:

"The provisions of section 5 shall not apply to any of the following transactions:

"(1) Transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except (a) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter, (b) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order and (c) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter. With respect to transactions referred to in subparagraph (b), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

"(2) Brokers' transactions, executed upon customers' orders on any exchange or in the over-the-counter market, but not the solicitation of such orders."

SEC. 12. The amendments made by this Act shall take effect as follows:

(1) The effective date of subsection 12(g)(1) of the Securities Exchange Act of 1934, as added by the Securities Act Amendments of 1963, shall be July 1, 1964.

(2) The effective date of the amendments to section 15(a) of said Act contained in the Securities Acts Amendments of 1963 shall be July 1, 1964.

(3) The amendments to section 15(d) of said Act contained in the Securities Acts Amendments of 1963 shall apply to every registration statement pursuant to the Securities Act of 1933 which becomes effective after the date of enactment of said amendments.

(4) All other amendments contained in the Securities Acts Amendments of 1963 shall take effect on the date of enactment.

[S. 1642, 88th Cong., 1st sess.]

AN ACT To amend the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, to extend disclosure requirements to the issuers of additional publicly traded securities, to provide for improved qualification and disciplinary procedures for registered brokers and dealers, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Securities Acts Amendments of 1963."

SEC. 2. Section 3(a) of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following four paragraphs:

"(18) The term 'person associated with a broker or dealer' means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, including any employee of such broker or dealer. The Commission may by rules and regulations classify, for the purpose of any portion or portions of this title, persons, including employees, controlled by a broker or a dealer. By rules and regulations the Commission shall appropriately exclude from the scope of subsection (b) (other than paragraph (3) thereof) of section 15 of this title persons associated with a broker or dealer whose functions are clerical or ministerial.

"(19) The terms 'investment company', 'affiliated person', and 'insurance company' have the same meanings as in the Investment Company Act of 1940.

"(20) The terms 'investment adviser' and 'underwriter' have the same meanings as in the Investment Advisers Act of 1940.

"(21) The term 'person associated with a member' means a person who is registered with a registered securities association pursuant to its rules or who is associated with a broker or dealer which is a member of such association."

SEC. 3. (a) Section 12(b) of the Securities Exchange Act of 1934 is amended as follows:

(1) Subparagraphs (I) through (K) of paragraph (1) are redesignated as (J) through (L), respectively.

(2) A new subparagraph (1)(I) is added to read as follows:

"(I) material contracts, not made in the ordinary course of business, which are to be executed in whole or in part at or after the filing of the application or which were made not more than two years before such filing, and every material patent or contract for a material patent right shall be deemed a material contract."

(3) A new paragraph (3) is added to read as follows:

"(3) Such copies of material contracts, referred to in paragraph (1)(I) above, as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security."

(b) Section 12(f) of said Act is amended to read as follows:

"(f) Notwithstanding the foregoing provisions of this section, any national securities exchange, subject to the terms and conditions hereinafter set forth, (1) may continue unlisted trading privileges to which a security had been admitted on such exchange prior to the effective date of subsection (g) (1) of section 12 of this title, or (2) upon application to and approval of such application by the Commission, may extend unlisted trading privileges to any security duly listed and registered on any other national securities exchange. If an extension of unlisted trading privileges to a security was originally based upon its listing and registration on another national securities exchange, such privileges shall continue in effect only so long as such security shall remain listed and registered on any other national securities exchange.

"No application pursuant to this subsection shall be approved unless the Commission finds, after appropriate notice and opportunity for hearing, that the extension of unlisted trading privileges pursuant to such application is necessary or appropriate in the public interest or for the protection of investors.

"The Commission shall by rules and regulations suspend unlisted trading privileges in whole or in part for any or all classes of securities for a period not exceeding twelve months, if it deems such suspension necessary or appropriate in the public interest or for the protection of investors or to prevent evasion of the purposes of this title.

"On the application of the issuer of any security for which unlisted trading privileges on any exchange have been continued or extended pursuant to this subsection, or of any broker or dealer who makes or creates a market for such security, or of any other person having a bona fide interest in the question

of termination or suspension of such unlisted trading privileges, or on its own motion, the Commission shall by order terminate, or suspend for a period not exceeding twelve months, such unlisted trading privileges for such security if the Commission finds, after appropriate notice and opportunity for hearing, that such termination or suspension is necessary or appropriate in the public interest or for the protection of investors.

"In any proceeding under this subsection in which appropirate notice and opportunity for hearing are required notice of not less than ten days to the applicant in such proceeding, to the issuer of the security involved, to the exchange which is seeking to continue or extend or has continued or extended unlisted trading privileges for such security, and to the exchange, if any, on which such security is listed and registered, shall be deemed adequate notice, and any broker or dealer who makes or creates a market for such security, and any other person having a bona fide interest in such proceeding, shall upon application be entitled to be heard.

"Any security for which unlisted trading privileges are continued or extended pursuant to this subsection shall be deemed to be registered on a national securities exchange within the meaning of this title. The powers and duties of the Commission under subsection (b) of section 19 of this title shall be applicable to the rules of an exchange in respect of any such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions, or for stated periods, exempt such securities from the operation of any provision of section 13, 14, or 16 of this title."

(c) Section 12 of said Act is further amended by adding thereto the following new subsection:

"(g) (1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall—

"(i) within one hundred and twenty days after the last day of its first fiscal year ended after the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and

"(ii) within one hundred and twenty days after the last day of its first fiscal year ended after two years from the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons

register such security by filing with the Commission a registration statement (and such copies thereof as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to register a security pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commisison or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 18 of this title. Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.

"(2) The provisions of this subsection shall not apply in respect of—

"(A) any security listed and registered on a national security exchange;

"(B) any security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940;

"(C) any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawable capital, issued by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution;

"(D) any security of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual; or

"(E) any security of a foreign issuer, including any certificate of deposit for such a security, unless the Commission, by rules or regulations, or by order after notice and opportunity for hearing, on its own motion finds that a substantial public market for the equity securities of such issuer or of a class of issuers which includes such issuer exists in the United States and that continued exemption of securities of such issuer or class of issuers is not in the public interest or consistent with the protection of investors.

"(3) Registration of any class of security pursuant to this subsection shall be terminated ninety days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than three hundred persons. The Commission shall after notice and opportunity for hearing deny termination of registration if it finds that the certification is untrue. Termination of registration shall be deferred pending final determination on the question of denial.

"(4) For the purposes of this subsection the term 'class' shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may for the purposes of this subsection define by rules and regulations the terms 'total assets' and 'held of record' as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection."

(d) Section 12 of said Act is further amended by adding thereto the following new subsection:

"(h) The Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from the provisions of subsection (g) hereof or from section 13, 14, or 15(d) of this title or may exempt from section 16 hereof any officer, director, or beneficial owner of securities of any issuer, any security of which is required to be registered pursuant to subsection (g) hereof, upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors. The Commission may, for the purposes of any of the above-mentioned sections or subsections of this title classify issuers and prescribe requirements appropriate for each such class."

(e) Section 12 of said Act is further amended by adding thereto the following new subsection:

"(i) In respect of any securities issued by banks the deposits of which are insured in accordance with the Federal Deposit Insurance Corporation Act, the powers, functions, and duties vested in the Commission under this title to administer and enforce sections 12, 13, 14(a), 14(c), and 16 thereof (1) with respect to national banks and banks operating under the Code of Law for the District of Columbia are vested in the Comptroller of the Currency, (2) with respect to all other member banks of the Federal Reserve System are vested in the Board of Governors of the Federal Reserve System, and (3) with respect to all other insured banks are vested in the Federal Deposit Insurance Corporation."

SEC. 4. Section 13(a) of the Securities Exchange Act of 1934 is amended to read as follows:

"(a) Every issuer of a security registered pursuant to section 12 of this title shall file with the Commission the information, documents, and reports below specified (and such copies thereof as the Commission may require) in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—

"(1) Such information and documents as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 12.

"(2) Such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports, as the Commission may prescribe.

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange."

SEC. 5. (a) Section 14(a) of the Securities Exchange Act of 1934 is amended to read as follows:

"(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title."

(b) Section 14(b) of said Act is amended to read as follows:

"(b) It shall be unlawful for any member of a national securities exchange, or any registered broker or dealer, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to give, or to refrain from giving a proxy, consent, or authorization in respect of any security registered pursuant to section 12 of this title and carried for the account of a customer."

(c) Section 14 of said Act is further amended by adding thereto the following new subsection:

"(c) Unless proxies, consents, or authorizations in respect of a security registered pursuant to section 12 of this title are solicited by or on behalf of the management of the issuer from the holders of record of such security in accordance with subsection (a) of this section and the rules and regulations thereunder, prior to any annual or other meeting of the holders of such security, such issuer shall, in accordance with rules and regulations prescribed by the Commission, file with the Commission and transmit to all holders of record of such security information substantially equivalent to the information which would be required to be transmitted if a solicitation were made; but no information shall be required to be filed or transmitted pursuant to this subsection before July 1, 1964."

SEC. 6. (a) Section 15(a) of the Securities Exchange Act of 1934 is amended to read as follows:

"(a) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer (A) is registered in accordance with subsection (b) of this section, and (B) is a member of a securities association which is registered pursuant to section 15A of this title.

"The Commission may by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for specified periods, exempt from clause (A) or (B), or both, of this subsection (a) any broker or dealer or class of brokers or dealers specified in such rules, regulations, or orders. Clause (B) of this subsection (a) shall be inapplicable with respect to: (i) all brokers and dealers during any period in which there is no registered securities association, and (ii) any broker or dealer during any period in which the rules of each registered securities association preclude the membership therein of such broker or dealer solely because of the geographical location of, or type of business done by, such broker or dealer."

(b) Section 15(b) of said Act is amended to read as follows:

"(b)(1) A broker or dealer may be registered for the purposes of this section by filing with the Commission an application for registration, which shall contain such information in such detail as to such broker or dealer and any persons associated with such broker or dealer as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine.

"An application for registration of a broker or dealer to be formed or organized may be made by a broker or dealer to which the broker or dealer to be formed or organized is to be the successor. Such application shall contain such information in such detail as to the applicant and as to the successor and any person associated with the applicant or the successor, as the Commission may by rules and regulations require as necessary or appropriate in the public

interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine. Such registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Commission may prescribe, adopt such application as its own.

"If any amendment to any application for registration pursuant to this subsection is filed prior to the effective date thereof, such amendment shall be deemed to have been filed simultaneously with and as part of such application; except that the Commission may, if it appears necessary or appropriate in the public interest or for the protection of investors, defer the effective date of any such registration as thus amended until the thirtieth day after the filing of such amendment.

"Any provision of this title (other than subsection (a) of this section and section 5) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any broker or dealer registered pursuant to this subsection or any person acting on behalf of such a broker or dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

"(2) The Commission shall, after appropriate notice and opportunity for hearing, by order censure, deny registration to, suspend for a period not exceeding twelve months or revoke the registration of, any broker or dealer if it finds that such censure, denial, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, (A) has willfully made to caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or (B) has been convicted within ten years preceding the filing of the application or at any time thereafter of any felony or misdemeanor which the Commission finds: (i) involves the purchase or sale of any security, (ii) arises out of the conduct of the business of a broker, dealer, or investment adviser, (iii) involves embezzlement, fraudulent conversion, or misappropriation of funds or securities, or (iv) involves the violation of section 1341, 1342, or 1343 of title 18, United States Code, as heretofore or hereafter amended; or (C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security; or (D) has willfully violated any provision of the Securities Act of 1933, or of the Investment Advisers Act of 1940, or of the Investment Company Act of 1940, or of this title, as any of such statutes heretofore have been or hereafter may be amended, or of any rule or regulation under any of such statutes; or (E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Investment Advisers Act of 1940, or the Investment Company Act of 1940, or of this title, as any such statutes heretofore have been or hereafter may be amended, or of any rule or regulation under any of such statutes or has failed reasonably to supervise, with a view to preventing violations of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision; or (F) is subject to an order of the Commission entered pursuant to paragraph (3) of this subsection (b) barring or suspending the right of such person to be associated with a broker or dealer, which order is in effect with respect to such person. For the purposes of clause (E) of this paragraph, no person shall be deemed to have failed reasonably to supervise any person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person; and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such

procedures and system without reasonable cause to believe that such procedures and system were not being complied with. Pending final determination whether any such registration shall be denied, the Commission may by order postpone the effective date of such registration for a period not to exceed fifteen days, but if, after appropriate notice and opportunity for hearing (which may consist solely of affidavits and oral arguments), it shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors to postpone the effective date of such registration until final determination, the Commission shall so order. Pending final determination whether any such registration shall be revoked, the Commission shall by order suspend such registration if, after appropriate notice and opportunity for hearing, such suspension shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors. Any registered broker or dealer may, upon such terms and conditions as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered broker or dealer, or any broker or dealer for whom an application for registration is pending, is no longer in existence or has ceased to do business as a broker or dealer, the Commission shall by order cancel the registration or application of such broker or dealer.

"(3) The Commission may, after appropriate notice and opportunity for hearing, by order censure any person, or bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer, if the Commission finds that such censure, barring or suspension is in the public interest and that such person has committed or omitted any act or omission enumerated in clause (A), (D) or (E) of paragraph (2) of this subsection (b) or has been convicted of any offense specified in clause (B) of said paragraph (2) within the time specified therein or is enjoined from any action, conduct, or practice specified in clause (C) of said paragraph (2). It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with a broker-dealer is in effect, willfully to become, or to be, associated with a broker or dealer, without the consent of the Commission, and it shall be unlawful for any broker or dealer to permit such a person to become, or remain, a person associated with him, without the consent of the Commission, if such broker or dealer knew, or in the exercise of reasonable care, should have known, of such order."

(c) Section 15(c) of said Act is amended by adding at the end thereof the following new paragraphs:

"(4) If the Commission finds, after notice and opportunity for hearing, that any person subject to the provisions of section 12, 13, or 15(d) of this title or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person to comply with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.

"(5) If in its opinion the public interest and the protection of investors so require, the Commission is authorized summarily to suspend trading, otherwise than on a national securities exchange, in any security (other than an exempted security) for a period not exceeding ten days. No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in which trading is so suspended."

(d) Section 15(d) of said Act is amended to read as follows:

"(d) Each issuer which has filed a registration statement containing an undertaking which is or becomes operative under this subsection as in effect prior to the date of enactment of the Securities Acts Amendments of 1963, and each issuer which shall after such date file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title in respect of a security registered pursuant to section 12 of this title. The duty to file under this subsection shall be automatically suspended if and so long as any issue of securities of such issuer is registered pursuant to section 12 of this title. The duty to file under this subsection shall also be automatically

suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons. For the purposes of this subsection, the term 'class' shall be construed to include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. Nothing in this subsection shall apply to securities issued by a foreign government or political subdivision thereof."

SEC. 7. (a) Secton 15A(b) of the Securities Exchange Act of 1934 is amended as follows:

(1) Paragraph (3) thereof is amended to read as follows:

"(3) the rules of the association provide that any broker or dealer who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, may become a member of such association, except such as are excluded pursuant to paragraphs (4) and (5) of this subsection: *Provided*, That the rules of the association may restrict membership in such association on such specified geographical basis, or on such specified basis relating to the type of business done by its members, or on such other specified and appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purpose of this section; rules adopted by the association may provide that the association may, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, deny admission to or refuse to continue in such association any broker or dealer if (i) such broker or dealer, whether prior or subsequent to becoming such, or (ii) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, has been and is suspended or expelled from a national securities exchange or has been and is barred or suspended from being associated with all members of such exchange, for violation of any rule of such exchange;".

(2) Paragraph (4) thereof is amended to read as follows:

"(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued in membership in such association, if (i) such broker or dealer, whether prior or subsequent to becoming such, or (ii) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, and who continues to be so associated after such broker or dealer knew or in the exercise of reasonable care should have known that such person (A) has been and is suspended or expelled from a registered securities association (whether national or affiliated) or from a national securities exchange or has been and is barred or suspended from being associated with all members of such association or from being associated with all brokers or dealers which are members of such exchange, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade, or (B) is subject to an order of the Commission denying, suspending for a period not exceeding twelve months or revoking his registration pursuant to section 15 of this title, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or barring or suspending him from being associated with a broker or dealer, or (C) by his conduct while associated with a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such broker or dealer, and in entering such a suspension, expulsion, or order, the Commission or any such exchange or association shall have jurisdiction to determine whether or not any person was a cause thereof;".

(3) Paragraphs (5) through (10) thereof are redesignated as paragraphs (6) through (11), respectively, and a new paragraph (5) is added to read as follows:

"(5) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall

become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such other qualifications of such person as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such member. For the purpose of defining such standards and the application thereof, such rules may (A) appropriately classify prospective members (taking into account relevant matters, including type of business done and nature of securities sold) and persons proposed to be associated with members, (B) specify that all or any portion of such standards shall be applicable to any such class, (C) require persons in any such class to pass examinations prescribed in accordance with such rules, (D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and such other qualifications as the association finds appropriate, (E) provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to the training, experience, financial responsibility, and other qualifications of the applicant and that the association may adopt procedures for verification of qualifications of the applicant, and (F) require any class of persons associated with a member to be registered with the association in accordance with procedures specified by such rules (and any application or document supplemental thereto required by such rules of a person seeking to be registered with such association shall, for the purposes of subsection (a) of section 32 of this title, be deemed an application required to be filed under this title)."

(4) Redesignated paragraph (9) thereof is amended to read as follows:

"(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules;".

(5) Redesignated paragraph (10) thereof is amended to read as follows:

"(10) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules shall require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include (A) a statement setting forth any act or practice in which such member or other person may be found to have engaged, or which such member or other person may be found to have omitted, (B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation, (C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade, and (D) a statement setting forth the penalty imposed. In any proceeding to determine whether a broker or dealer shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the broker or dealer or person shall be notified of, and be given an opportunity to be heard upon, the specific grounds for denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based; and".

(6) Section 15A(b) of said Act is further amended by adding two unnumbered paragraphs at the end thereof, to read as follows:

"The rules of the association shall include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be disseminated by any member or any person associated with a member, and the persons to whom such quotations may be

supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations.

"The provisions of this subsection, as in effect prior to the date of enactment of the Securities Acts Amendments of 1963, shall be applicable to the rules of any registered securities association which was registered on such date until July 1, 1964. After July 1, 1964, the Commission may, after notice and opportunity for hearing, suspend the registration of any such association if it finds that the rules thereof do not conform to the requirements of this subsection, as amended by section 7 of the Securities Acts Amendments of 1963, and any such suspension shall remain in effect until the Commission issues an order determining that such rules have been modified to conform with such requirements."

(b) Section 15A(d)(2) of said Act is amended by striking out "(9)" and inserting in lieu thereof "(10)".

(c) Section 15A(g) of said Act is amended to read as follows:

"(g) If any registered securities association (whether national or affiliated) shall take any disciplinary action against any member thereof or any person associated with such a member or shall deny admission to any broker or dealer seeking membership therein, or shall bar any person from being associated with a member, such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the Commission may determine. Application to the Commission for review, or the institution or review by the Commission on its own motion, shall operate as a stay of such action until an order is issued upon such review pursuant to subsection (h), unless the Commission shall otherwise order, after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments)."

(d) Section 15A(h) of said Act is amended to read as follows:

"(h)(1) In a proceeding to review disciplinary action taken by a registered securities association against a member thereof or a person associated with a member, if the Commission, after appropriate notice and opportunity for hearing, upon consideration of the record before the association and such other evidence as it may deem relevant, shall (A) find that such member or person has engaged in such acts or practices, or has omitted such act, as the association has found him to have engaged in or omitted, and (B) shall determine that such acts or practices, or omission to act, are in violation of such rules of the association as have been designated in the determination of the association, the Commission shall by order dismiss the proceeding, unless it appears to the Commission that such action should be modified in accordance with paragraph (2) of this subsection. The Commission shall likewise determine whether the acts or practices prohibited, or the omission of any act required, by any such rule constitute conduct inconsistent with just and equitable principles of trade, and shall so declare. If it appears to the Commission that the evidence does not warrant the finding required in clause (A), or if the Commisison shall determine that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the association, or that such act as is found to have been omitted is not required by such designated rule or rules, the Commission shall by order set aside the action of the association.

"(2) If, after appropriate notice and opportunity for hearing, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

"(3) In any proceeding to review the denial of membership in a registered securities association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing, and upon consideration of the record before the association and such other evidence as it may deem relevant, shall determine that the specific grounds on which such denial or bar is based exist in fact and are valid under this section, the Commission shall by order dismiss the proceeding; otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant broker or dealer to membership therein, or to permit such person to be associated with a member."

(e) Section 15A (k) (2) of said Act is amended to read as follows:

"(2) The Commission may in writing request any registered securities association to adopt any specified alteration of or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modifications of such alteration or supplement as it deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section, with respect to: (A) The basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof; (B) the method for adoption of any change in or addition to the rules of the association; (C) the method of choosing officers and directors; and (D) affiliation between registered securities associations."

(f) Section 15A (2) of said Act is amended to read as follows:

"(2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a registered securities association any member thereof, or to suspend for a period not exceeding twelve months or to bar any person from being associated with a member thereof, if the Commission finds that such member or person (A) has violated any provision of this title or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this title or any rule or regulation thereunder, or (B) has willfully violated any provision of the Securities Act of 1933, as amended, or of any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was willfully violating with respect to such transaction any provision of such Act or rule or regulation."

SEC. 8. (a) Section 16(a) of the Securities Exchange Act of 1934 is amended to read as follows:

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to subsection (g) of section 12 of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange) a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

(b) Section 16 of said Act is further amended by redesignating subsection (d) as subsection (e) and adding a new subsection (d) as follows:

"(d) The provisions of subsection (b) of this section shall not apply to any purchase and sale, or sale and purchase, and the provisions of subsection (c) of this section shall not apply to any sale, of an equity security not then or theretofore held by him in an investment account, by a dealer in the ordinary course of his business and incident to the establishment or maintenance by him of a primary or secondary market (otherwise than on a national securities exchange or an exchange exempted from registration under section 5 of this title) for such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, define and prescribe terms and conditions with respect to securities held in an investment account and transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market."

SEC. 9. Section 20(c) of the Securities Exchange Act of 1934 is amended to read as follows:

"(c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this title or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information."

SEC. 10. Section 32 of the Securities Exchange Act of 1934 is amended by striking out subsection (b) and by redesignating subsection (c) as subsection (b).

SEC. 11. Section 4 of the Securities Act of 1933 is amended to read as follows:

"SEC. 4. The provisions of section 5 shall not apply to any of the following transactions:

"(1) Transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except (a) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter, (b) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and (c) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter. With respect to transactions referred to in clause (b), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

"(2) Brokers' transactions, executed upon customers' orders on any exchange or in the over-the-counter market, but not the solicitation of such orders."

SEC. 12. The amendments made by this Act shall take effect as follows:

(1) The effective date of section 12(g)(1) of the Securities Exchange Act of 1934, as added by section 3(c) of this Act, shall be July 1, 1964.

(2) The effective date of the amendments to sections 12(b) and 15(a) of the Securities Exchange Act of 1934, contained in sections 3(a) and 6(a), respectively, of this Act, shall be July 1, 1964.

(3) All other amendments contained in this Act shall take effect on the date of its enactment.

Passed the Senate July 30, 1963.

Attest:

FELTON M. JOHNSTON,
Secretary.

EXECUTIVE OFFICE OF THE PRESIDENT,
BUREAU OF THE BUDGET,
Washington, D.C., November 14, 1963.

HON. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your request for the views of the Bureau of the Budget on H.R. 6789 and S. 1642, the Securities Acts Amendments of 1963.

Both bills would (1) extend disclosure requirements to companies whose securities are traded in the over-the-counter market, (2) strengthen the standards for entry into the securities business, etxend the coverage of self-regulation, and improve disciplinary controls, and (3) assure more adequate information about companies raising public capital for the first time.

H.R. 6789 represents the draft legislation transmitted by the Securities and Exchange Commission after full review by the executive agencies concerned. As passed by the Senate, S. 1642 contains no major differences in substance from H.R. 6789, but would make it mandatory rather than discretionary for the Federal bank supervisory agencies to administer the provisions requiring certain banks whose securities are traded in over-the-counter markets to meet the reporting requirements, proxy rules, and insider-trading provisions of the Securities Exchange Act.

The Bureau of the Budget concurs with the Securities and Exchange Commission that in this respect the primary objective should be to assure that the protections of the bill are made available for investors in bank securities. Accordingly, enactment of either S. 1642 or H.R. 6789 would be in accord with the program of the President.

Sincerely yours,

(Signed) PHILLIP S. HUGHES,
Assistant Director for Legislative Reference.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
June 21, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your communication of June 10, 1963, requesting a report on H.R. 6789, a bill to amend the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Board of Governors is not in a position to comment on the provisions of the bill that relate to strengthening the standards of entrance into the securities business, extending the coverage of self-regulation, and the like. For reasons described herein, the Board's principal concern is with provisions of the bill that are designed to improve investor protection in the over-the-counter market by extension of reporting requirements, proxy rules, and insider-trading provisions of the Securities Exchange Act of 1934—now applicable only to "listed companies"—to certain companies whose securities are traded in the over-the-counter market.

The Board is in agreement with the purpose of the proposed new section 12(g) of the Securities Exchange Act, which is to provide for stockholders of corporations whose securities are widely distributed, but not registered on an exchange, the information and safeguards which that act requires with respect to securities that are so registered. Furthermore, the Board believes that application of the new provisions to stocks of banks, as well as to stocks of other corporations, is in the public interest. While the adding of the proposed requirements to the present system of bank regulation and supervision would necessitate careful administration in order to avoid inconsistency, duplication, unreasonable demands, and undesirable disclosures, the Board is satisfied that the requirements can be administered in such a way as to avoid serious problems of this kind.

However, the Board doubts the advisability of section 3(e) of H.R. 6789, which would add to section 12 of the 1934 act the following new subsection:

"(i) In respect of any securities issued by banks the powers, functions, and duties of the Commission pursuant to the provisions of this title shall be delegated in whole or in part to the Federal banking regulatory agency or instrumentality which has jurisdiction to examine or supervise the business of such banks, upon the request of such agency or instrumentality."

Enclosed herewith is a memorandum commenting upon a number of problems raised by the wording of the proposed new subsection. For the purpose of this report, however, it will be assumed that the purpose and effect of this subsection would be to enable each of the Federal bank supervisory agencies to take the place of the Securities and Exchange Commission with respect to administration of the reporting, proxy, and "insider trading" provisions of the act as they apply to the banks as to which it is the principal Federal supervisor.

It would be desirable, of course, for the administration of the proposed reporting requirements and proxy rules to take into account the special situation of banks, especially the extent to which banks are already subject to govern-

mental supervision. Nevertheless, the Board considers it inadvisable to provide that these and other provisions of the Securities Exchange Act of 1934, in their application to banks, may be administered by an agency other than the Commission.

The proposed new section 12(i) contemplates that administration of the provisions of the 1934 act with respect to the subjects mentioned might be vested in the Comptroller of the Currency as to national banks, in the Board of Governors as to State banks that are members of the Federal Reserve System, and in the Federal Deposit Insurance Corporation as to nonmember banks with deposits insured in accordance with the Federal Deposit Insurance Act. Under such an arrangement, responsibility would be fragmented and the tasks performed less efficiently. It would be necessary for each of those agencies to expand its organization and to maintain staff that would perform for banks work that would be performed by the Commission with respect to corporations generally.

Accordingly, the Board concludes that the reporting, proxy, and "insider trading" provisions of the 1934 act should be administered by the Commission in their application to banks as well as in their application to corporations generally, and therefore recommends the deletion of section 3(e) of H.R. 6789. (If this recommendation is followed, it will be unnecessary for your committee to consider certain apparent shortcomings and difficulties in the wording of the proposed new subsection (i) of section 12 of the 1934 act, which are enumerated in the enclosed memorandum.)

Sincerely yours,

WM. MCC. MARTIN, JR.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
Washington, D.C., August 23, 1963.

HON. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your communication of August 13, 1963, requesting a report on S. 1642, a bill to amend the Securities Act of 1933 and the Securities Exchange Act of 1934.

This bill, which passed the Senate on July 30, 1963, is substantially similar to H.R. 6789 on which the Board reported in its letter to you of June 21, 1963. A copy of that letter is enclosed herewith for your convenient reference. (A memorandum enclosed with that letter, regarding the language of section 3(e) of H.R. 6789, is not enclosed with this letter, since the memorandum is not pertinent to the language of S. 1642.)

As stated in its letter of June 21, the Board is principally concerned with those provisions of the bill that would extend reporting requirements, proxy rules, and insider-trading provisions of the Securities Exchange Act to certain corporations, including banks, whose securities are traded in the over-the-counter market. The Board believes that such provisions should be applicable to banks and that they should be administered by the Securities and Exchange Commission in the case of banks as well as in the case of corporations generally. For this reason, the Board questioned the advisability of section 3(e) of H.R. 6789 which would have provided for the delegation of the Commission's functions with respect to banks to the Federal bank regulatory agencies upon the request of such agencies.

As amended and passed by the Senate, S. 1642, the bill now before your committee, would require the reporting, proxy, and insider-trading provisions of the bill to be administered by the appropriate Federal bank regulatory agencies in the case of banks, instead of providing for delegation of the Commission's functions in this respect upon request of the banking agencies.

The views expressed by the Board in its letter of June 21 are equally applicable to S. 1642; and, therefore, the Board recommends the deletion of section 3(e) of that bill. In the Board's opinion, fragmentation of responsibility for administration of the provisions of the bill applicable to banks, as contemplated by section 3(e), would result in inequities, inefficiency, and unnecessary confusion. However, if your committee should nevertheless endorse, and if the Congress should enact, S. 1642 in its present form, the Board is prepared to carry out the new responsibilities that would be placed upon it.

Sincerely yours,

(Signed) WM. MCC. MARTIN, JR.

U.S. DEPARTMENT OF JUSTICE,
OFFICE OF THE DEPUTY ATTORNEY GENERAL,
Washington, D.C., November 27, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Department of Justice concerning H.R. 6789 and H.R. 6793, identical bills, and S. 1642, a substantially identical bill, to amend the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, to extend disclosure requirements to the issuers of additional publicly traded securities, to provide for improved qualification and disciplinary procedures for registered brokers and dealers, and for other purposes.

These measures, which may be cited as the Securities Acts Amendments of 1963, represent the draft legislation which was submitted to the President of the Senate and the Speaker of the House of Representatives, on June 4, 1963, by the Chairman of the Securities and Exchange Commission, William L. Cary.

The need for this legislation, its purpose, and effect are discussed in the Securities Exchange Commission's letter of submission and accompanying explanatory statement.

The Department of Justice has no objection to the enactment of any of the subject bills.

The Bureau of the Budget has advised that enactment of the proposed legislation would be in accord with the program of the President.

Sincerely yours,

NICHOLAS DEB. KATZENBACH,
Deputy Attorney General.

OFFICE OF THE POSTMASTER GENERAL,
Washington, D.C., November 14, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your request for a report on S. 1642, an act amending the Securities Act of 1933 and the Securities and Exchange Act of 1934 to require certain corporations whose stock is traded over the counter to file registration statements, annual and other reports, and providing improved qualification and disciplinary procedures for registered brokers and dealers.

This act does not materially affect the operations of the Post Office Department. We therefore have no comments to make with respect to the merits of the legislation or suggestions for any changes.

The Bureau of the Budget has advised that from the standpoint of the administration's program there is no objection to the submission of this report to the committee.

Sincerely yours,

JOHN A. GRONOUSKI,
Postmaster General.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 26, 1963.

Re H.R. 6789, 88th Congress.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: This is in response to your letter of June 10, 1963, in which you request a report on H.R. 6789. That bill embodies recommendations made by this Commission for amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934. As you know, those recommendations are based upon the first part of a report of the Special Study of Securities Markets undertaken by the Commission pursuant to the provisions of Public Law 87-196.

S. 1642, companion bill to H.R. 6789, was introduced (by request) by Senator

A. Willis Robertson and hearings were held on that bill during the latter part of June. At those hearings the views of this Commission on the need for the proposed amendments were set forth in detail. It is our understanding that your committee will hold hearings on H.R. 6789 during the latter part of the summer and it is anticipated that our views on the bill will be set forth in similar detail at that time. However, if you should desire a report of our views prior to such hearings, we shall be happy to furnish it to you.

I am enclosing a copy of my statement before the Senate Subcommittee.

With best wishes,

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington D.C., August 26, 1963.

Re S. 1642, 88th Congress.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing in response to your letter of August 15 in which you request this Commission's comments on S. 1642. That bill embodies recommendations made by this Commission for amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, with certain modifications made by the Senate Committee on Banking and Currency. As you well know, the Commission's recommendations were based upon the first part of a report of the Special Study of Securities Markets undertaken by the Commission pursuant to the resolution of your committee which was embodied in Public Law 87–196.

At the Senate hearings on S. 1642 the views of the Commission on the need for the proposed amendments were set forth in detail. Now that the Senate has passed the bill with a few minor amendments, it is my understanding that you expect to hold hearings next month on H.R. 6789, a companion bill to S. 1642. Our views will, of course, be set forth in similar detail at that time. However, if you should desire a report prior to such hearings, we shall be happy to furnish it to you.

With best wishes.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

FEDERAL DEPOSIT INSURANCE CORPORATION,
Washington, November 19, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Although the views of the Federal Deposit Insurance Corporation have not been requested on H.R. 6789, a bill to amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to extend disclosure requirements to the issuers of additional publicly traded securities, and for other purposes, I feel the legislation proposed by this bill is of sufficient significance to the Corporation that my personal views thereon should be submitted to your committee.

As you are aware, since the expiration of the term of former Chairman Erle Cocke, Sr., Mr. James Saxon, Comptroller of the Currency, has been Acting Chairman of the Corporation. Inasmuch as Mr. Saxon, as Comptroller of the Currency, may express his views on the subjects in which you are interested. I cannot express the official position of the Corporation on these matters. Accordingly, the views presented herein represent my own personal views on H.R. 6789.

One of the sections of the bill which is of major importance to this Corporation is section 3(c), which would add a new subsection (g) to section 12 of the Securities Exchange Act of 1934, and would initially require every issuer of securities, including banks, engaged in interstate commerce, or in a business affecting interestate commerce, or whose securities are treated by use of the mails or other means of interstate commerce, and having total assets exceeding $1 million and which has a class of equity securities (other than exempted securities) held of record by 750 or more persons, to file with the Securities and

Exchange Commission a registration statement with respect to such class of securities containing, in essence, the same information required in section 12(b) of the Securities Exchange Act of 1934 from an issuer making application to register a security on a national securities exchange. After 2 years, or for a longer period if the Commission so determines, the stockholder requirement would drop to 500 persons.

Section 3(e) of the bill would further amend section 12 of the Securities Exchange Act of 1934 so as to provide for the delegation of the responsibility for administering the provisions requiring such information to be reported from banks issuing such securities to the appropriate Federal banking regulatory authority, which in the case of insured State banks which are not members of the Federal Reserve System, would be the Federal Deposit Insurance Corporation.

In considering this bill it should be noted that when the Senate Committee on Banking and Currency considered S. 1642, a bill identical to H.R. 6789, the Corporation suggested an amendment to section 3(e) of S. 1642 to provide, in substance, that in respect of any securities issued by insured banks, the powers, functions, and duties vested in the Securities Exchange Commission to administer and enforce sections 12, 13, 14(a), 14(c), and 16 of the Securities Exchange Act of 1934 would be vested in the appropriate Federal banking supervisory authorities. This amendment was incorporated in S. 1642, as reported by the Committee on Banking and Currency, and as subsequently passed by the Senate. Accordingly, it is my recommendation that if Congress should enact H.R. 6789 that the statute itself should specifically place the powers, functions, and duties with respect to public disclosures in connection with bank securities issuers in the appropriate Federal banking supervisory authority, rather than in the Securities and Exchange Commission with authority in that Commission to delegate such powers, functions, and duties in whole or in part to such agencies.

On the other hand, if Congress should follow the recommendations of the Comptroller of the Currency contained in his testimony before the Senate Banking and Currency Committee on S. 1642 with respect to his authority over public disclosures by national banks, I would recommend that comparable statutory authority be extended to the Federal Deposit Insurance Corporation with respect to insured State banks which are not members of the Federal Reserve System, and to the Board of Governors of the Federal Reserve System with respect to State banks which are members of that system.

These views being personal, they have not been submitted to the Bureau of the Budget. However, substantially the same views with respect to granting of original authority to the Securities Exchange Commission were submitted by the Corporation on S. 1642 to the Bureau of the Budget, which advised that it had no objection from the standpoint of the administration's program to the submission of the Corporation's report on S. 1642.

Sincerely yours,

JESSE P. WOLCOTT, *Director.*

Mr. STAGGERS. In addition, the subcommittee will also take up the Commission's recommendations relating to changes in the rules of the exchanges and the securities associations, which it feels necessary for the protection of investors, that it believes may be accomplished by the Commission's rulemaking authority. These we shall consider in the light of what the Commission has done to treat by rule of these changes for the protection of investors; of what the Commission intends to do; and in some respects of why the Commission has not engaged in this rulemaking procedure in the past where it has had the power, and the need for the Commission's action has been present.

In such connection, too, it may well be appropriate to develop those fields which the Commission did not go into in its study, although authorized and directed to do so.

I regret that my own preliminary remarks have been at some length, but I feel that it is our desire to have a complete record in this matter, which is of such importance to the investing public and the public at large, and to the development of which this subcommittee and the entire committee have been dedicated now for some years.

It is my understanding, Chairman Cary, that you have two statements to present to the committee, one which is specifically aimed at a discussion of the legislation which the Commission has proposed, and the second, a complete review of the results of the study and of the Commission's recommendations flowing from such study which the Commission intends to effectuate through its rulemaking powers.

I don't know what your pleasure is, Chairman Cary, as to giving both statements without interruption or having presented the one relating to legislative proposals first, and opening yourself to questions thereon. It may be that the two statements are interdependent, and for a full understanding of the one, we will need both.

I would like to say before we proceed that to me this is like the structure of a building. In 1961, some of the people in America decided the building belonged to them, and that it needed some repairing, and demanded that it be repaired. A committee was set up to find out whether the roof needed repairing and what else needed repairing, and whether the repair work was done.

There are some who have said that perhaps the building does not need any repair, but to let it stand. We think the building is sound and whole. We think by the results of the study and the recommendations, after being fully discussed, that any weaknesses or any misuse will be corrected either by rulemaking or by legislation, or by direction of this Congress.

Now, Mr. Cary, you may proceed.

STATEMENT OF WILLIAM L. CARY, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY BYRON D. WOODSIDE, COMMISSIONER; MANUEL F. COHEN, COMMISSIONER; JACK WHITNEY II, COMMISSIONER; PHILIP S. LOOMIS, JR., GENERAL COUNSEL; EDMUND H. WORTHY, DIRECTOR, DIVISION OF CORPORATION FINANCE; ALLAN F. CONWILL, DIRECTOR, DIVISION OF CORPORATE REGULATION; RALPH S. SAUL, DIRECTOR, DIVISION OF TRADING AND MARKETS; WALTER WERNER, DIRECTOR, OFFICE OF PROGRAM PLANNING, ANDREW BARR, CHIEF ACCOUNTANT; ARTHUR FLEISCHER, JR., EXECUTIVE ASSISTANT TO THE CHAIRMAN; AND MORGAN SHIPMAN, SPECIAL COUNSEL, OFFICE OF PROGRAM PLANNING, SECURITIES AND EXCHANGE COMMISSION

Mr. CARY. Mr. Chairman, I very much appreciate the opportunity to be here. I think I should introduce those who are with me. My colleagues are in the center, Commissioner Woodside, Commissioner Cohen, Commissioner Whitney.

We also have with us our General Counsel, Philip Loomis; the Director of the Division of Corporation Finance, Edmund Worthy; the Director of our Division of Corporate Regulation, Allan Conwill; the Director of our Division of Trading and Markets, Ralph Saul; the Director of our Office of Program Planning, Walter Werner; our chief accountant, Andrew Barr; my executive assistant, Arthur Fleischer; and our special counsel in the Office of Program Planning, Morgan Shipman.

As you said a moment ago, Mr. Chairman, I do have two statements. I would be happy to be interrupted between them or, at your discretion, at any time, needless to say. With your permission, I would like first to take up the statement relating to the bill, and then proceed to the statement which, in a general way, attempts to give the background of the House resolution; what we proceeded to do; the nature of the Report of the Special Study; and what we have done on the basis of that report—in other words, how it is presently being implemented.

As a consequence, I thought I might start with the first and perhaps more formidable document which relates to the bill itself.

I am here to testify on three bills, having the designations H.R. 6789, H.R. 6793, and also in the Senate, S. 1642. They embody our legislative recommendations. They are also, as you have said, identical, having been introduced by yourself, Chairman Staggers, and by Chairman Harris. The Senate bill, which passed the Senate on July 30 of this year, differs only in limited aspects from its House counterpart. I do expect to mention that difference when we come to that point.

I would like to emphasize that the Commission accepts and supports all of the amendments made by the Senate bill.

H.R. 6789, an amendment to the Securities Exchange Act of 1934 and, in one respect, to the Securities Act of 1933, is designed to deal with areas where the present statutory structure of the securities acts is inadequate and vitally in need of strengthening. In the unanimous opinion of the Commission, the enactment of H.R. 6789 will represent a major achievement in securities regulation by materially increasing existing investor protection and thus maintaining and enhancing investor confidence.

This bill on which we are testifying today is a most important consequence of the Report of the Special Study of Securities Markets which was authorized and directed by the Congress in Public Law 87–196. The proposed amendments contained in H.R. 6789 are in substantial part based upon and supported by that report.

In its broadest terms, H.R. 6789 has two major purposes. The first is to improve investor protection in the over-the-counter market, primarily by extending fundamental disclosure requirements. Disclosures now furnished by listed companies would be required also of companies whose securities are traded in the over-the-counter market, and in which there is a substantial public interest.

The second major purpose is to strengthen qualification standards and controls over those in the securities business, again with emphasis on the over-the-counter market. We stress that these purposes are interrelated and have a common goal—the raising of standards in the securities markets. Improved standards in the securities markets are best assured by the combination of better information about securities, on the one hand, and better qualified persons to utilize and evaluate that information on the other. Each proposal in H.R. 6789 would be an important advance; but it is the sum of all of them which will produce the maximum benefit in the public interest.

I would first like to discuss those sections of the bill dealing with improved and expanded disclosure for over-the-counter securities.

A. OUTLINE OF PROVISIONS WITH RESPECT TO THE EXTENSION OF DISCLOSURE REQUIREMENTS TO OVER-THE-COUNTER COMPANIES

H.R. 6789 would extend to investors in over-the-counter securities the fundamental protections now generally afforded by the Securities Exchange Act of 1934 only to investors in securities listed on an exchange. These protections may be briefly described as follows:

(1) Under sections 12 and 13 of the Exchange Act, a company which lists its securities on an exchange must file a registration statement containing material financial and business information concerning its operations.

(2) Pursuant to section 14 of the Exchange Act, security holders whose votes are solicited by corporate management, or others, must be furnished with a proxy statement. This statement must contain adequate and accurate information so that the corporate franchise may be intelligently exercised.

(3) Under section 16 of the Exchange Act, corporate "insiders," that is, officers, directors, and 10-percent stockholders, are restricted in their use of inside information for personal benefit. These insiders must report their securities transactions; the corporation may recover their trading profits made within a 6-month period; and they are not allowed to sell short.

All of these protections are now available in the over-the-counter market only to investors in securities of public utility holding company systems and closed-end investment companies. In addition, by virtue of section 15(d) of the Exchange Act, the reporting requirements do apply to over-the-counter companies, presently about 1,800 in number, that register a public offering of securities with the Commission and the value of the class of securities offered and outstanding is over $2 million. Investors in all other companies do not receive the benefits of these protections.

Sections 3, 4, 5, and 8 of H.R. 6789 will make these fundamental safeguards applicable to over-the-counter market. Initially, companies having more than $1 million in assets and a class of equity securities held of record by 750 or more persons would be required to register with the Commission and assume the obligations of listed companies. After 2 years, or a longer period if the Commission so determines, the stockholder requirement would drop to 500.

These two standards would result in an estimated additional coverage of 3,100 and 3,900 companies, respectively. In the case of banks, the bill contemplates that the functions of the Commission would be administered by the appropriate Federal banking regulatory agency upon its request.

Now may I mention the fundamental difference between the House bill and the Senate bill?

Under the Senate bill, the jurisdiction would vest directly in the banking agencies. In other words, it is mandated to those agencies.

Mr. HARRIS. Mr. Chairman, I do not want to interrupt with questions about the legislation, but I would like to ask a question on procedure at this moment.

Mr. STAGGERS. Mr. Harris?

Mr. HARRIS. The bills that you sent up, Mr. Cary, to the House and Senate, in the usual way, with "Dear Mr. Speaker," and "Dear

Mr. Vice President" letters were identical in the House, were they not?

Mr. CARY. That is correct.

Mr. HARRIS. And they were introduced by the distinguished chairman of this subcommittee and myself, and the chairman of the Senate Banking Committee, as you sent them up?

Mr. CARY. That is correct.

Mr. HARRIS. Did the Senate then amend the bill which it passed which makes a difference?

Mr. CARY. It did amend the bill; that is correct. At the hearings, Chairman Harris, we had a very substantial discussion of this matter of whether or not the handling of the reporting and other requirements under this bill would be done first of all by the SEC or by a Federal banking regulatory authority.

Mr. HARRIS. I don't intend to get into the reasons for it at this time. I just wanted to have an understanding of why the difference between the House bill that was introduced and the Senate-passed bill.

Mr. CARY. The Senate chose to amend it. They wanted to amend it and mandate the authority over the reporting requirements with respect to bank stocks to the proper Federal banking regulatory authority.

Mr. HARRIS. Since then, the Commission has come to the viewpoint that it prefers the Senate-amended bill over your own original bill as sent up?

Mr. CARY. Yes, sir.

Mr. HARRIS. I just wanted to get that clear, Mr. Chairman.

Mr. KEITH. Mr. Chairman——

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. What time would be appropriate to question Mr. Cary as to the reasons for that change?

Mr. STAGGERS. I believe we were going to let him complete his statement, unless you feel it is necessary to interrupt now.

Mr. KEITH. I don't think it is necessary now. I just wanted to express some concern for this.

Mr. CARY. Mr. Chairman, bearing on the point that Congressman Keith has raised, there is a segment of this paper focused on the banks, as such. The two crucial issues in this area—where there have been questions raised—have been primarily with respect to bank stocks and insurance stocks. For that reason, a very substantial part of this discussion will be on the bank stocks first, as I recall, and then insurance.

The policy supporting this expansion of the basic disclosure philosophy of the securities acts into the over-the-counter market has long been recognized. So has the need. Both have been strongly confirmed by the report of the Special Study which contains a detailed analysis and statistical survey of the problem in chapter IX. The securities industry and other important groups have indicated their agreement that these disclosure protections are needed. In fact, in the Senate hearings on S. 1642, there was general support for the extension of these provisions to over-the-counter companies; the most significant question raised concerned the coverage of companies in certain fields—primarily banks and insurance companies.

B. THE BASIC DISCLOSURE PHILOSOPHY OF THE SECURITIES ACTS

The keystone of the entire structure of Federal securities legislation is disclosure. Making available to investors adequate financial and other information about securities is the best means of enabling them to make intelligent investment decisions and of protecting them against securities frauds.

I have an extended statment from this committee in its report accompanying the 1934 act. I will omit quotation of that, although I would like to have those parts which I omit as part of the record, if I may.

Mr. STAGGERS. That may be done.

Mr. CARY. I will move to the middle of page 8.

There is no convincing reason why the comprehensive scheme of disclosure that benefits the exchange markets should not also apply in the over-the-counter market. Nothing in the nature of the securities traded in that market or in its mechanics makes any less necessary the disclosure of basic information about its companies. On the contrary, because the over-the-counter market includes not only widely known and seasoned companies, but also relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great as, if not greater than, in some exchange markets. The over-the-counter market has become a significant institution in channeling the flow of investor capital and has undergone a spectacular growth in the last decade. A brief summary of that development will perhaps clearly demonstrate its importance.

C. GROWTH IN THE OVER-THE-COUNTER MARKET

The recognized need for adequate protection in the over-the-counter market has been greatly accentuated by its expansion and increasing importance, as vividly documented by the report of the Special Study.

The average number of stocks quoted in the daily "sheets" of the National Quotation Bureau, circulated among dealers in the over-the-counter market, increased from 5,000 in 1946 to 8,200 as of January 15, 1963. Moreover, during a 10-month period in 1961 and 1962, quotations were entered in over 14,000 different domestic stocks traded exclusively in the over-the-counter market.

In addition, over-the-counter sales of corporate stocks excluding sales of mutual fund shares and syndicated distributions, increased almost 700 percent in 12 years, from an estimated $4.9 billion in 1945 to $38.9 billion in 1961. The importance of the over-the-counter market is further reflected in the fact that, considering only public sales, the volume of over-the-counter stock transactions in 1961 amounted to approximately 75 percent of exchange transactions in terms of shares and 35 percent in terms of dollars.

Companies with stocks traded exclusively in the over-the-counter market constitute an important sector of our economy. A Special Study sample of over 1,600 of these companies showed that 31 percent had assets of over $10 million, 47 percent had assets of over $5 million, and 77 percent had assets of $1 million or more. Approximately one-half had $500 or more record shareholders, and 16 percent had 2,000 or more.

Thus, it is clear this is not a modest market, nor are these modest companies with which we are dealing. A substantial public interest needs to be served.

D. THE NEED FOR DISCLOSURE IN THE OVER-THE-COUNTER MARKET

The lack of basic investor protection in the over-the-counter market has made informed investment judgment difficult, has created grave difficulties for the professionals in the securities market who try to fulfill their responsibilities to provide sound investment advice to the public, and has introduced an artificial factor in the allocation of securities between the exchange and over-the-counter markets. It has further deprived investors of important bulwarks against fraud.

Eloquent testimony of investor needs is provided by investors themselves. The largest number of public complaints received by the Commission concern requests for information about over-the-counter companies with respect to which the public has little or no adequate information. The public should not be asked to buy and sell in darkness, nor can professionals in the securities markets advise them properly in the absence of reliable information. An analyst attempting to assess the investment worth of a company which does not file reports may be unable to find adequate or reliable data in the financial manuals. He often is relegated to the choice of utilizing that information which management chooses to make public, or expending considerable effort and expense in making his own investigation.

The entire report of the Special Study is a documented analysis of the necessity for disclosure. The report demonstrates that irresponsible selling tactics, reckless investment advice, extravagent financial public relations, and erratic markets for new issues of securities flourish best where lack of information is most marked.

One deplorable manifestation of these ill effects is reflected in the fact that the overwhelming preponderance of securities fraud cases in past years have involved over-the-counter securities. Vigorous enforcement efforts by the Commission cannot be a full substitute for preventive measures which would be far less costly to the taxpayer and to the victimized investor.

May I say parenthetically at this point, Mr. Chairman, that in our justification, which is submitted as part of the record, is a memorandum covering a very large number of fraud cases involving over-the-counter securities. This gives a sample of some of the situations with which we have been faced.

The availability of reliable sources of information has been a vital protection against fraud in listed securities. It enables members of the public to protect themselves against high-pressure sales campaigns by checking the representations made. Moreover, the requirement of periodic disclosure makes concealment by corporate manipulators more difficult and risky.

At the same time, information disclosed in filed reports has been of considerable assistance in the detection, investigation, and prosecution of violations of the Federal securities laws, as when it provides the first suggestion of a possible illegality.

Because of the crucial disparity between the exchanges and the over-the-counter market, that market undoubtedly fails to receive

the measure of confidence which it might otherwise enjoy. Thus, the public may draw a fairly sharp line in its investments, as it appears to have done after the market break of a year and a half ago. It is well known that the over-the-counter market has not shown the same resiliency since that sharp decline as the exchange markets, either in terms of price or of volume.

Experience under the Federal securities laws has proven that providing basic investor protection encourages a healthy development of the securities markets. If the present double standard is eliminated, investor confidence in the over-the-counter market will be increased, the ability of companies to raise necessary capital will be enhanced, and securities will gravitate to the market best suited to them.

Moreover, the extension of the disclosure requirements of the Exchange Act to a significant portion of the over-the-counter market undoubtedly will have an effect on the entire market. The initial application of the disclosure philosophy to trading markets on national securities exchanges has created an appreciation of, and an expectation for, regular and continuous information. For this reason, many over-the-counter companies, both large and small, have been persuaded that confidence can best be maintained by voluntarily making adequate discolsures to shareholders. Enactment of H.R. 6789 should greatly accelerate this trend.

The need of the over-the-counter market for the benefits offered by this legislation is clear—a need recognized by the securities industry and important elements of the business community. In its report on S. 1168, 85th Congress, a bill similar in purpose to H.R. 6789, the Senate Committee on Banking and Currency recognized the inadequacies of the present protection afforded investors in the over-the-counter market:

> The principle of equal treatment by the law of listed and unlisted large corporations in requiring them to furnish financial information to investors has received thorough consideration for nearly a quarter of a century. Many of the arguments against S. 1168 are the same as those advanced against the original Securities Exchange Act of 1934. It is significant that many of the groups opposing the original laws have now become its staunch supporters because of its protection to investors and its furthering of the public interest. The committee believes that the same recognition of the public interest will follow the enactment of S. 1168.

The need has not diminished, nor is it theoretical. The over-the-counter market has grown tremendously in securities traded and in number of investors. Only the protections have stood still.

E. EXAMINATION OF REPORTING BY OVER-THE-COUNTER COMPANIES

The disclosure habits of over-the-counter companies confirm the justifications in logic and policy for a statutory base of responsibility.

The study analyzed the reporting practices of 556 companies—other than banks and insurance companies, treated separately—which were selected on a random basis. Deficiencies ranged from a failure to distribute any reports to shareholders on the part of a significant number of companies—25 percent—to important defects in the disclosures of numerous others. The results of the Special Study's examination of proxy solicitation practices of these same companies were even more striking. Many did not even solicit proxies—24 per-

cent. Of those that did, a clear majority omitted such vital information as the names or experience of nominees for directors—84 percent—or the remuneration of the management—95 percent.

The findings of the Special Study do indicate that disclosure patterns tend to improve with increased shareholder ownership. This improvement would, of course, be reflected in those companies with $1 million of assets and 500 shareholders that will be covered by H.R. 6789. Nevertheless, in companies of that category included in the Special Study survey, significant inadequacies were found in reporting customs. Thirteen percent did not distribute any financial information to shareholders in 1961. Of those that did, in 12 percent of the cases it was not certified by an independent public accountant.

The proxy solicitation practices of these companies showed even greater need of improvement. Seventeen percent did not furnish any material to stockholders during 1961; 62 percent of the companies which solicited proxies involving election of directors did not disclose the names of nominees; and 92 percent made no disclosure of the remuneration of management. Significant deficiencies were found in many other respects.

The study's review of financial reporting habits would indicate—to the extent permitted by such an examination—that some companies presently furnish adequate information. A company making such voluntary disclosures should have no objection to continue doing so under a congressionally endorsed policy.

Most importantly, investors in over-the-counter securities are entitled to be assured that corporate reporting meets all the tests of timeliness, sound accounting, reliability, responsibility, and consistency. This can be achieved only by the imposition of legal obligations which would shape the development of appropriate accounting and other disclosure practices.

Moreover, in the absence of statutory requirements, it cannot be expected that in times of corporate stress—when the need for full and accurate information is most acute—managements will necessarily disclose, on a voluntary basis, matters which may tend to reflect adversely on their activities or on their companies.

F. OVER-THE-COUNTER COMPANIES COVERED BY H.R. 6789

The necessity for disclosure has long been recognized. The extent of coverage of any disclosure requirements, however, has been a more difficult issue from the point of view of both the size and type of company to be covered.

The Special Study made a particular effort to develop appropriate tests and also especially examined the disclosure practices of banks and insurance companies, examples of regulated industries which have raised special questions in the past and also during the Senate hearings on the bill.

H.R. 6789 would extend sections 12, 13, 14, and 16 of the Exchange Act initially to those companies having $1 million in total gross assets and 750 stockholders of record. After a 2-year period, or at such later date as the Commission may determine, the shareholder test would be reduced to 500.

It is estimated that under the 750 shareholder standard, approximately 3,100 companies would be covered of which about 400 would be banks, subject to the appropriate Federal banking regulatory agency. About 1,500 of the remaining 2,700 are already required to file reports with the Commission under section 15(d) of the Exchange Act. In other words, this group of companies are already required to provide reporting information, they are not required at this time to furnish initial proxy information when they solicit the proxies or are not subject to the insider trading provision.

Under the 500 shareholder standard, the estimated coverage is 3,900 companies including 1,700 companies already reporting and 600 banks.

The selection of the recommended standard of coverage, necessarily a matter of judgment, is based on several factors. Most influential among these is investor interest as evidenced by the number of shareholders. In principle these provisions might apply to all companies in which "public" investors have an equity interest. Such inclusive coverage, however, could create a burden on companies and the Commission unwarranted by the importance of these companies in the marketplace.

Accordingly, the criteria for inclusion of companies have been chosen with a view that the flow of reports and proxy statements would be manageable from the administrative standpoint and not disproportionately burdensome on companies in relation to the needs to be served.

Companies with 500 and over shareholders and $1 million in assets are affected by a substantial investor interest.

In the report's analysis of companies meeting the statutory tests (other than banks and insurance companies), 40 percent had over $10 million in assets; at the lower end of the scale, only 15 percent had between $1 and $2 million in assets. Thus, it would appear that the great majority of the companies subject to the bill will be very substantial in size and that the companies satisfying the minimum requirements are not small enterprises in any real sense of the word. The public interest is further underlined by findings of the report as to the significant trading activity in the securities of a majority of the covered companies.

Any burdens of compliance with H.R. 6789 are minimal when compared to the benefits of adequate disclosure provided by the bill.

In this connection, weight should be given to the statement of Mr. Edwin D. Etherington, president of the American Stock Exchange, on S. 1642 before the Securities Subcommittee of the Senate Committee on Banking and Currency, as follows:

> * * * we conclude that the total cost of annual compliance with all of the requirements now applicable to listed companies apparently would be in the area of $1,500 to $3,000 for the smaller industrial companies covered by this bill except in most unusual circumstances.

Furthermore, Mr. James E. Day, president of the Midwest Stock Exchange, estimated that the costs to smaller and medium size over-the-counter companies to meet the requirements of S. 1642 should not be more than $1,500 to $2,000 except in the most unusual cases; "and for many of the firms who were now using legal counsel for tax purposes and receiving regular CPA audits, as low as $500 more than they were now paying."

It is primarily because of the anticipated administrative load, particularly in the years immediately following the effectiveness of H.R. 6789, that section 3(c) embodies a phasing down in coverage; that is, from 750 at the outset to 500 at the end of 2 years or such later time as we find reasonable.

At the same time this will permit a reasonable period for preparation by the affected companies.

Moreover, if for any reason the Commission could not accommodate the increased number of companies filing under the lower standard as scheduled, it could defer operation of that standard. Since the pertinent provisions of H.R. 6789 would not become effective until July 1, 1964, companies will generally not register until sometime in 1965. Costs of the program to the Commission for fiscal year 1965 are estimated at approximately $600,000.

Now, Mr. Chairman, if I may, I would like to move on to the bank securities specifically, as I mentioned a moment earlier, and then into the matter of insurance company securities.

DISCLOSURE WITH RESPECT TO BANK SECURITIES TRADED IN THE OVER-THE-COUNTER MARKET

H.R. 6789 would apply to over-the-counter banks meeting the statutory standards. However, the bill also provides that all the powers, functions, and duties of the Commission with respect to bank securities shall be delegated to the appropriate Federal banking regulatory authority upon its request.

S. 1642 as passed by the Senate contains one difference in treatment of bank stocks from H.R. 6789. Under the Senate bill, the administration and enforcement of the disclosure, proxy, and insider trading provisions of the Exchange Act with regard to the bank stocks would be directly vested or mandated in the Federal bank regulatory agency with primary examining and supervisory authority—the Comptroller of the Currency for national banks; the Federal Reserve Board for member State banks; and the Federal Deposit Insurance Corporation for nonmember, insured State banks.

As the Senate committee report indicates, the reasons for the Senate amendment were essentially to assure integration of the disclosure requirements with the Federal bank regulatory structure and to avoid a situation where some, but not all, banking agencies would request administration of the applicable 1934 act provisions.

That may help to answer an inquiry, I think, you were making, Mr. Chairman, about why the Senate thought they ought to mandate it directly to the agencies. They thought that one agency, for example the Comptroller of the Currency, might request the authority to administer this and that another agency might not. Therefore, there would be disuniformity in treatment by the various Federal banking regulatory authorities.

The Commission supports this amendment, which is but a short step from S. 1642 as introduced and H.R. 6789. Our goal is the establishment of the principle of disclosure, proxy, and insider trading requirements for bank stocks.

The report of the Special Study demonstrates the substantial importance of over-the-counter bank stocks both in terms of number of shareholders and amount of dollars invested. Approximately one-

fifth of the securities designated in the 3-month period covered by the January 1962 summary of the National Quotation Bureau, Inc., were bank stocks.

Further data from the Special Study indicates that approximately 600 banks would be covered by H.R. 6789. Moody's Bank and Finance Manual for 1963 lists over 550 banks meeting the coverage standards.

The aggregate number of shareholders of these banks (without adjustment to eliminate duplication) was approximately 1,600,000 and the aggregate market value of the bank stocks held by these investors, as of December 31, 1962, was about $22.5 billion.

These figures illustrate the extremely broad investor interest in over-the-counter bank stocks and the corresponding need for the disclosure requirements now recommended generally for over-the-counter companies. Do investors in bank stocks need this protection any less than other investors? At the hearings on S. 1642, there was general support—by Chairman Martin of the Federal Reserve Board, by the American Bankers Association, and by others—of the principle of adequate disclosure for bank stocks.

The only significant question raised at the hearings related to administration of these provisions; whether by the Commission; or by the banking agencies, if they requested the responsibility as proposed in H.R. 6789; or directly by the banking agencies as contained in S. 1642.

As we have noted, the Commission supports the amended bill. In sum, we have no desire to take direct responsibility over bank disclosure in any respect. It is only the principle of adequate disclosure, administered by Federal agencies, which we assert.

Accordingly, the only remaining issue is whether present practices of banks are such that the purposes of H.R. 6789 have already been satisfied.

The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. These objectives neither utilize the same tools nor achieve the same ends as investor protection.

The purpose of disclosure is to place the investor in a position to make an informed judgment on the merits of a security, and to provide a basis for comparing that security with others issued by companies in the same or different industries. Essentially this purpose is achieved through the furnishing of financial information which provides a uniform pattern of reporting based on understood and generally accepted accounting practices. To say that bank regulation renders this disclosure philosophy unnecessary is to say that bank regulation is an effective substitute for the free exercise of an investor's judgment.

Controls which protect against embezzlement and which assure adequate reserves serve important objectives, but not the objective of informed investment. To hold otherwise would be to imply that, because of such regulation, any bank security is, without more, a worthy investment at any price.

The emphasis in the objectives of banking regulations is manifested in its financial reporting requirements. A key report in investment analysis, the income statement, is filed on a confidential basis with

the banking authorities and, except at the option of a particular bank, is not available to the public. No attention is given to the protection of investors in proxy solicitations with the exception of recent efforts of the Comptroller of the Currency. Nor are there any restrictions with respect to insider trading.

The inadequacies of this reporting structure for the investor's purposes have been brought out by the report of the Special Study. Its analysis revealed that the disclosure practices of banks fall far short of the standards imposed under section 13, 14, and 16 of the Exchange Act.

In the category of banks that would be covered by H.R. 6789, the report's findings show that 10 percent did not send any financial information to their shareholders. Of those that did, 32 percent failed to include the most important document, a profit-and-loss statement. These conclusions are illustrative of the fact that uniformity of reporting to provide some basis for comparing banks stocks among themselves or with other stocks has been notably lacking.

Significant deficiencies, moreover, were also found in the proxy practices of banks. For example, in 88 percent of the solicitations that involved election of directors, the names of the nominees were not stated and in 95 percent their experience was not given. In all cases management remuneration was not furnished.

There have been recent efforts on the part of the Comptroller of the Currency to provide by annual reporting and proxy rules some protections for banks investors. These steps represent a pioneering effort by the Comptroller and a welcome recognition of the need for action.

I have pointed out in the next paragraph wherein the regulations do fall below those contemplated by the Exchange Act, but I will not read that to the committee.

The facts of the matter are that the regulations of the Comptroller under any circumstances are only applicable to some national banks and leave a large number of banks not covered.

The regulations of the Comptroller have been adopted pursuant to his general authority to require special reports. There is, of course, no established congressional expression of policy as to the content of reports for stockholders and consequently no assurance of their endurance.

Furthermore, to the extent that these regulations already provide protections equivalent to those afforded by the Exchange Act, there would appear to be little cause for objection to their express congressional approval in a statute providing for their administration by appropriate banking authorities.

For these reasons the Commission strongly recommends that investors in bank stocks be given the basic protections afforded by H.R. 6789—protections to be administered by the proper banking authorities.

Mr. Chairman, that concludes the part discussing banks. I didn't know whether it was your pleasure to have any questions that might be raised with respect to banks at this time or if you wish me to continue.

Mr. STAGGERS. I think it would be wise to proceed with the rest of your statement.

Mr. CARY. Very well, Mr. Chairman.

Moving on to disclosure with respect to insurance securities traded on the over-the-counter market—and I understand from the press and otherwise that that is perhaps the area in which there is likely to be the most discussion—the Special Study gave special attention to stock insurance companies because of the claim that existing State regulation makes superfluous the application of the disclosure protections provided by H.R. 6789.

The report of the Special Study found these stock companies were an important part of the over-the-counter market in accounting for approximately 5 percent of the domestic issues traded. We estimate that about 400 insurance companies meet the standards of H.R. 6789, of which approximately a third are already subject to our reporting rules. The information available on these 400 companies indicate that they have over 1,300,000 shareholders and the market value of their outstanding shares is over $20 billion.

It is strikingly evident that insurance companies represent substantial centers of investor interest.

Accordingly, unless persuasive reasons exist to the contrary, there would appear to be no justification for depriving investors in insurance companies of those benefits afforded investors in other over-the-counter securities. The Commission believes that no such justification exists.

It should be pointed out that mutual companies, which were not examined by the Special Study, are not subject to the bill. They do not have stockholders as such; and, even more important, there are no shares being traded.

In other words, the point is that, in connection with mutual companies, the people who are buying them are not buying shares but are buying policies. That is the basic difference. You don't have shares in which there is trading involved.

From the beginning, Congress has been of the view that investors in insurance companies need all of the protections afforded by the Federal securities laws to investors in other businesses. When an insurance company goes to the public for funds, it must comply with the Securities Act of 1933; similarly, such a company is covered by the Exchange Act. Thus, approximately 150 insurance companies—and I find that as of the present date it is 171—including about 114 life insurance companies, are now subject to the reporting requirements of that act as a result of having made a registered offering of securities. The market value of the shares of 126 of these insurance companies (as to which information is presently available) is over $5 billion; their number of stockholders is estimated at approximately 700,000.

Existing regulation of insurance companies, which rests almost exclusively in the hands of the States, is designed primarily for the safeguarding of policyholders and is an inadequate substitute for the investor protections provided by H.R. 6789.

Again it should be emphasized that the bill is intended to foster publication of reliable financial and business data so as to allow investors to exercise a rational judgment and thereby to promote an informed distribution of capital among companies and industries.

The thrust of insurance regulation is to protect policyholders'

claims against a company. Accordingly, the stress is laid upon the adequacy of reserves and upon investment in conformity with specified standards. Consistent with those aims, information in the required reports is directed to the solvency of a company and not to its usefulness for making investment decisions.

In other words, a company may be sound enough to meet its obligations, from the standpoint of the insurance commissions, but its stock may or may not be an attractive investment or speculation at current prices. No one, not even a sophisticated financial analyst, can arrive at a judgment as to a stock's merits unless there is adequate information available. Disclosure, therefore, is necessary to protect at least 1,300,000 owners already having more than $20 billion invested in the insurance companies covered by the bill—as well as the potential investors in this active area of the markets.

H.R. 6789 would provide nonfinancial information not now generally available under State insurance regulation. For example, a State report, and, by the way, the State reports are very full, the reports to the State Commissioners or superintendents of insurance, typically contains only limited data concerning material transactions of insiders in comparison with the requirements of the Commission's rules.

Moreover, there is no provision under State regulation for timely disclosure of events of major importance to investors, such as major acquisitions of assets, significant litigation, or the issuance of substantial amounts of stock.

In contrast, the Commission's form 8–K, the filing of which would be required by H.R. 6789, must be filed soon after the occurrence of any of these material events.

Furthermore, State regulation has nothing comparable to the Commission's proxy rules, which place financial and business information in the hands of the shareholders, nor does it provide any substitute for the various safeguards against insider trading.

The Special Study's examination of the reporting practices of insurance companies confirms that State regulation has not in the past produced the flow of necessary basic information that will result from H.R. 6789.

In the category of companies in the study survey that would be covered by H.R. 6789, 12 percent failed to furnish any financial information to shareholders and 50 percent did not supply an income statement.

Proxy soliciting practices were even more inadequate. Eight percent of the companies responding did not transmit any proxy material to shareholders. When shareholders were furnished these materials, the information provided was almost always greatly inadequate by standards applicable to listed companies.

The serious weaknesses in this area were noted in a 1960 report by a subcommittee within the National Federation of Financial Analysts Societies:

> It is our conclusion that annual reports (to stockholders) of the life insurance industry are the poorest of any major industry in the United States.

There may well have been improvements since that date; the findings of the report seem to indicate they are modest ones.

Insurance companies should be the first to appreciate a primary aim of H.R. 6789—to provide investors with adequate information. They continuously invest other people's money and rely on the adequacy and reliability of the disclosures about the companies in which they invest. Those who invest in insurance companies should be entitled to no less reliable information.

The importance of publishing and disseminating financial information about a company, of course, rests firmly on the desirability of informed investor judgment. However, the absence of this information is also conducive to fraudulent practices and overreaching, which have occurred in recent years with an undesirable frequency in insurance company promotions. The assets and liabilities of insurance companies are usually of an intangible nature and, despite the vigilance of the State insurance commissioners, opportunities do exist for manipulation of these assets and liabilities by insiders in a manner detrimental to the interests of investors.

The insurance business has grown rapidly in the last decade. During the 10-year period from 1951–61, the number of life insurance companies in the United States has more than doubled, from 659 to 1,457, with a high concentration of this growth in the South and Southwest. Many of the new insurance companies which emerged during this period were inevitably promotional to some degree and their operations presented problems of investor protection.

In its 23d annual report (1957), the Commission, describing its most pressing enforcement problems, included this statement:

> Recent economic conditions have been relatively favorable for the sale of promotional stocks of new ventures, particularly in fields in which the securities of established enterprises have shown marked gains. For example, many new insurance and financial ventures have been promoted, particularly in the south central, southwestern, and southeastern parts of the country, and their securities have been distributed either through registration or regulation A, or more commonly in reliance upon the intrastate exemption. Many of these issues and the sales techniques employed in their distribution appear to involve abuses and possible violations of the antifraud and other provisions of the Securities Act or the Securities Exchange Act, which require extensive investigation. The large number of these promotions and the rapidity with which they have increased has placed a most serious burden on the Commission's field enforcement personnel charged with the conduct of such investigations.

Similar statements were made in the 22d and 24th annual reports of the Commission and these problems have not disappeared.

Special questions, and I have had this inquiry from a number of sources since this bill has been filed, have been raised with regard to the financial reporting problems of life insurance companies. I should therefore like to describe the Commission's procedures and requirements respecting these companies—an area in which the Commission has already had broad experience, as evidenced by the 114 life insurance companies now filing annnual and periodic reports.

At the outset a few basic points should be noted. First, the enactment of H.R. 6789 will not introduce new accounting regulations or alter the accounting practices of life insurance companies. There will be no need for a separate set of books or the establishment of new procedures.

Second, life insurance companies can satisfy the financial reporting requirements of the Exchange Act essentially by filing the reports prepared annually for State authorities. Indeed, these reports must conform to the requirements of the State insurance commissions.

Third, the reports filed with the Commission need not be certified by independent public accountants. That is a notion which appears to be generally held, but it simply is not true.

These points reflect present Commission policies. The Commission has made very clear in a letter to Senator Robertson during the hearings on S. 1642 that it expects to continue to follow these policies in the future and the Senate committee report stated it expects the Commission to do so.

I should briefly like to expand on these points, which are embodied in proposed article 7–A to our regulation S–X. This proposed article specifically governs the financial statements of life insurance companies and basically embodies Commission practices. Comments have been received on the proposal and, as revised, it will be presented to the Commission for adoption after further conferences with interested parties.

I should first reemphasize that the financial reports filed by life insurance companies under the Exchange Act are not required to be recorded, certified, or audited by independent public accountants. Company officials may, in effect, file with us the financial statements which they file with the State insurance commissioners, together with certain additional explanatory notes. There is apparently an erroneous impression in the life insurance industry that an independent audit would be required under the bill. The facts are that the financial work of the company's own employees exclusively will be accepted under H.R. 6789. This has been the practice of the Commission for 30 years and, as I have stated, we are committed to continue it.

Moreover, article 7–A of regulation S–X does not prescribe any method of reporting which is inconsistent with the methods of reporting required in the annual statement blank adopted by the National Association of Insurance Commissioners. Indeed, the proposed article does not require the reporting of any financial information to the Commission which cannot be obtained from data contained in some form in the uniform NAIC annual statement or which is not otherwise readily available. The only difference between the reporting that will be required by the proposed Commission article and that currently required by the States is that the former will include substantially less detailed information pertaining to insurance matters than that included in the NAIC statement. The only other change is that the proposed article would require certain brief explanatory notes, including a historical analysis of surplus, for the benefit of investors not conversant with insurance accounting practices and terminology.

I have gone into these points in more detail in letters to Chairman Harris and to certain of the State insurance commissioners, and I would like to offer this letter for the record.

Mr. STAGGERS. They may be included in the record.

(The letter to Mr. Harris follows:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 30, 1963.

HON. OREN HARRIS,
House of Representatives,
Washington, D.C.

DEAR MR. HARRIS: This is in reply to your letter of August 14, 1963, requesting our comments on a letter you received expressing opposition to S. 1642 insofar as it would include "small life insurance companies." You describe this letter as representative of many being received by you and other Members of the Congress.

As you know, S. 1642 has passed the Senate and is now pending before the House, along with its House counterparts, H.R. 6789 and H.R. 6793. For convenience in this letter, I shall designate the pending legislation by reference to H.R. 6789.

I

H.R. 6789 would apply the reporting requirements, proxy rules, and insider trading provisions of the Securities Exchange Act of 1934—presently applicable to listed companies—to any over-the-counter company having more than $1 million of assets and a class of equity securities held of record by 750 or more persons. After 2 years, or a longer period if the Commission determined, the stockholder requirement would drop to 500. H.R. 6789 applies to stock companies, not mutual insurance companies, because the latter do not have stockholders as such; and—even more important—there are no shares being traded. Thus, in answer to the letter, the bill does not "discriminate" in favor of mutual companies; the same need for investor protection does not exist for them.

The report of the Special Study of Securities Markets found that stock insurance companies, on the other hand, constitute an important part of the over-the-counter market and urged that investors in them need the same protections as investors in other over-the-counter companies. The Commission strongly agrees with this recommendation, and stock insurance companies are covered by H.R. 6789. However, the bill does not blanket in small companies. As already stated, no company having less than 750 shareholders (or 500 after 2 years) is involved. We estimate that only about 400 insurance companies meet the standards of H.R. 6789, of which approximately a third are already subject to our reporting rules. The information available on these 400 companies indicates that they have over 1,300,000 shareholders and the market value of their outstanding shares is over $20 billion. It is thus clear that insurance companies represent substantial centers of investor interest in the over-the-counter market.

II

The letter states the opinion that insurance companies are now quite adequately regulated by State insurance authorities. From the beginning, Congress has been of the view that investors in insurance companies need all of the protections afforded to those in all other businesses by the Federal securities laws. When an insurance company goes to the public for funds, it must comply with the Securities Act of 1933 and provide complete information. Moreover, approximately 150 insurance companies, including about 100 life insurance companies, are now subject to the reporting requirements of the Exchange Act as a result of having made a registered offering of securities. The market value of the shares of 126 of these insurance companies (as to which information is presently available) is over $5 billion; their number of stockholders is estimated at approximately 700,000.

Existing State regulation of insurance companies, designed primarily to safeguard policyholders, is not an adequate substitute for the investor protections provided by H.R. 6789. The functions of H.R. 6789 are to make available reliable financial and business data as a base for the exercise of informed investment judgment and to prevent abuses by insiders in securities trading. The aim of insurance regulation, on the other hand, is to safeguard policyholders' claims against a company. Accordingly, the stress is laid upon the adequacy of reserves and upon investment in conformity with specified standards. In other words, a company may be sound enough to meet its obligations, but its stock may or may not be a worthwhile investment for the public. No one, not even a sophisticated financial analyst, can arrive at a judgment as to a stock's merits unless there is adequate information available. Disclosure, therefore, is necessary to protect at least 1,300,000 owners already having more than $20 billion invested in the insurance companies covered by the bill.

The special study's examination of the reporting practices of insurance companies confirms that State regulation has not in the past produced the flow of necessary basic information that will result from H.R. 6789. In the category of insurance companies studied in the special study report that would be covered by H.R. 6789, 14 percent failed to furnish any financial information to stockholders and 50 percent failed to supply an income statement. Proxy soliciting practices were even more inadequate. The serious weaknesses in disclosure practices were noted in a 1960 report by a group of financial analysts: "It is our couclusion that annual reports [to stockholders] of the life insurance

industry are the poorest of any major industry in the United States," 12th Annual Report, National Federation of Financial Analysts Societies, page 12 (1960). Of course, the general protections against abuses by insiders in securities transactions have no general counterpart in State insurance regulation.

Insurance companies should be the first to appreciate a primary aim of H.R. 6789—to provide investors with adequate information; they continuously invest other people's money and rely on the adequacy and reliability of the disclosures about the companies in which they invest. Those who invest in insurance companies should be entitled to no less reliable information.

III

The various disclosure requirements of H.R. 6789 also have a beneficial effect in protecting against overreaching—of importance in the insurance company industry where there has been extensive promotional activity. The insurance company business has expanded immensely in the last decade: from 1951 to 1961 life insurance firms in the United States have more than doubled, from 659 to 1,457, with a high concentration of this growth in the South and Southwest. Many of these companies which emerged during this period were inevitably promotional to some degree and their activities posed problems of investor protection. In its 23d annual report (1957) this Commission, describing its most pressing enforcement problems, included this statement:

"Recent economic conditions have been relatively favorable for the sale of promotional stocks of new ventures, particularly in fields in which the securities of established enterprises have shown marked gains. For example, many new insurance and financial ventures have been promoted, particularly in the south-central, southwestern, and southeastern parts of the country, and their securities have been distributed either through registration or regulation A, or more commonly, in reliance upon the intrastate exemption. Many of these issues and the sales techniques employed in their distribution appear to involve abuses and possible violations of the antifraud and other provisions of the Securities Act or the Securities Exchange Act, which require extensive investigation. The large number of these promotions and the rapidity with which they have increased has placed a most serious burden on the Commission's field enforcement personnel charged with the conduct of such investigations."

Similar statements were made in the 22d and 24th annual reports of the Commission, and these problems have not disappeared. In this connection, I enclose a copy of a memorandum submitted during the hearings on S. 1642 which details certain fraud cases involving over-the-counter insurance companies.

IV

The letter has also raised questions concerning the costs of compliance with the reporting and registration provisions of the pending legislation. As we have already stated, H.R. 6789 is applicable only to those companies with 500 shareholders of record and $1 million in gross assets. In the study's analysis of insurance companies meeting the statutory tests, over 50 percent had over $10 million in assets; at the lower end of the scale, only 18 percent had between $1 and $2 million in assets. Thus, it would appear that the great majority of the companies subject to the bill will be very substantial in size and that the companies meeting the minimum requirements are not small enterprises in any real sense of the word.

Companies with 500–750 shareholders and $1 million in assets are affected by a substantial investor interest. Any burdens of compliance with H.R. 6789 are minimal when compared to the benefits of adequate disclosure provided by the bill in these cases. In this connection, weight should be given to the statement of Mr. Edwin D. Etherington, president of the American Stock Exchange, on S. 1642 before the Securities Subcommittee of the Senate Committee on Banking and Currency, as follows:

"(w)e conclude that the total cost of annual compliance with all of the requirements now applicable to listed companies apparently would be in the area of $1,500 to $3,000 for the smaller industrial companies covered by this bill except in most unusual circumstances."

Furthermore, Mr. James E. Day, president of the Midwest Stock Exchange, estimated that the costs to smaller and medium size over-the-counter companies to meet the requirements of H.R. 6789 should not be more than $1,500 to $2,000

except in the most unusual cases: "and for many of the firms who were now using legal counsel for tax purposes and receiving regular CPA audits, as low as $500 more than they were now paying."

As in the case of over-the-counter companies generally, there is no indication that insurance companies will encounter difficulties in satisfying the provisions of H.R. 6789. Indeed, an important expense for most companies, included in the estimates above, will be an audit by an independent certified public accounting firm which is not required for life insurance reports under Commission practice. Moreover, insurance companies must already file detailed financial reports in each State exercising jurisdiction over them and presumably have adquate staffs to cope with the reporting requirements of State regulation. Their compliance with H.R. 6789 should prove to be a matter of relatively small additional cost and burden. This fact is understood by the practice of the Commission to accept, in lieu of the financial reports required under sections 12 and 13 of the Exchange Act, excerpts from the State financial reports, supplemented by brief explanatory notes.

V

The letter further questions whether the Commission is equipped to handle the reporting problems of life insurance companies. I should like to describe briefly the Commission's procedures and requirements with respect to financial reporting by life insurance companies—an area in which the Commission has already had broad experience, as evidenced by the approximately 100 life insurance companies now filing annual and periodic reports.

Because of the numerous life insurance companies subject to the Securities Acts, the Commission has recently proposed the adoption of article 7–A to our regulation S–X specifically governing their financial statements. Comments have been received on this proposal and, as revised, it will be presented to the Commission for adoption after further conferences with the industry.

It should be emphasized that article 7–A does not prescribe any method of reporting which is inconsistent with the methods of reporting required in the annual statement blank adopted by the National Association of Insurance Commissioners. Indeed, the proposed article does not require the reporting of any financial information to the Commission which cannot be obtained out of the uniform NAIC annual statement or which is not otherwise readily available. The basic difference between the reporting that will be required by the proposed Commission article and that currently required by the States is that the former will include substantially less information than that included in the NAIC statement. The only other change is that the proposed article would require certain brief explanatory notes, including a historical analysis of surplus, for the benefit of investors not conversant with insurance accounting practices and terminology. In short, the information required by the Commission will be condensed and rearranged for the use of investors—to achieve a simplification of the financial presentation—and will permit the omission of a substantial amount of detail prescribed by the State insurance commissioners.

Thus, the enactment of H.R. 6789 will not alter the accounting practices of life insurance companies. There will be no need for a separate set of books. These points should be absolutely crystal clear and I attempted to settle them in a letter to Senator Robertson during the hearings on S. 1642. In that letter I stated as follows:

"I should also add that the Commission has accepted, and would continue to accept, in lieu of the financial reports required under sections 12 and 13 of the Securities Exchange Act, copies of the annual statement prepared for submission to State authorities, or parts thereof, supplemented by brief explanatory notes as referred to above. It should also be noted that under present requirements financial statements required to be filed by life insurance companies under the Securities Exchange Act need not be certified."

In the preceding paragraphs I have devoted attention to the Commission's financial reporting requirements with respect to life insurance companies. I have emphasized that these requirements can be basically satisfied from the information filed with State authorities. It should further be brought out that H.R. 6789 would provide nonfinancial information not now generally available under State insurance regulation. For example, a State report typically contains only limited data concerning material transactions of insiders in comparison with the requirements of the Commission's rules. Moreover, there is no pro-

vision under State regulation for timely disclosure of events of major importance to investors such as mergers, acquisitions, and the issuance of substantial amounts of stock. In contrast, the Commission's form 8–K, the filing of which would be required by H.R. 6789, must be filed soon after the occurrence of any of these material events. Furthermore, State regulation has nothing comparable to the Commission's proxy rules and required reporting of securities transactions by insiders. We have already noted the seriously deficient quality of the proxy statements and annual reports which life insurance companies presently distribute.

In the opinion of the Commission it is most important that insurance companies be included under H.R. 6789. The Senate has approved this judgment in its passage of S. 1642 and the Commission will strongly urge the House of Representatives to do the same.

We hope that this letter adequately answers the questions raised. If you feel that we can be of any further assistance in this matter, please do not hesitate to call upon us.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Mr. CARY. We stress that, as in the case of over-the-counter companies generally, insurance companies will not encounter difficulties or incur significant expenses in satisfying the provisions of H.R. 6789. Indeed, an important expense for most companies will be an audit by an independent certified public accounting firm—which is not required for insurance company reports under Commission practice.

Moreover, as we have pointed out, insurance companies must already file detailed financial reports in each State exercising jurisdiction over them and presumably have adequate staffs to cope with the reporting requirements of State regulation. Their compliance with H.R. 6789 should prove to be a mater of relatively small additional cost and burden.

To further coordinate our efforts with the insurance commissioners, we have suggested to them that it would be possible, if the National Association of Insurance Commissioners so desired, to modify the convention blank by adding an additional page of notes after the principal financial statements containing the explanatory material which we need. Should this be done, a life insurance company could simply file with us a copy of its filing with the State insurance commissioners as full compliance with the financial portion of its report.

It should also be kept in mind that the great majority of life insurance companies subject to the bill will be very substantial in size and that the companies meeting the minimum requirements are not small enterprises in any real sense of the word. In the study's analysis of insurance companies meeting the statutory tests, over 50 percent had over $10 million in assets; at the lower end of the scale, only 18 percent had between $1 and $2 million in assets.

Finally, in this connection, I note that, of the estimated 400 insurance companies that would be covered by the bill, 126 are already required to file periodic reports with the Commission under section 15(d) of the Exchange Act. For these companies, the chief additional expense will be in complying with the proxy requirements of the bill.

In summary, the importance of insurance companies to the public as a medium of investment is undeniable. Yet the information available about many of these companies is totally inadequate. It seems clear that only H.R. 6789 will provide that minimum amount of data necessary for informed investing. Because of the applicability of the

reporting requirements to almost 150 insurance companies, investors in some of these companies are already receiving partial protection. Complete protection for investors in all insurance companies meeting the statutory standards is necessary and desirable.

In opposing the provisions of the bill, representatives of insurance companies have pointed to the possibility of action in the areas covered by the bill by the National Association of Insurance Commissioners, which then presumably would be implemented by the 50 States. Undoubtedly any developments with respect to proxy or insider trading regulation would require action by the 50 State legislatures. Thus, there would be no guarantee of immediate response, or assurance of uniform standards.

The findings of the study demonstrate that action is needed now. Because of the widespread investor interest in insurance companies—not limited to State lines—that action should be on the Federal level and in the context of a statute which applies to all companies, whatever their business, and establishes nationwide, uniform minimum standards. The necessity for such standards in the securities markets, of course, was a basic reason for enactment of the Federal securities laws.

Moreover, it is clear that H.R. 6789 would not infringe upon action by the States; for example, the various States could impose more restrictive rules on insider trading than those contained in the bill. All of the Federal Securities Acts specifically allow action by the States in the areas covered, limited only by a requirement that such State action not be inconsistent with the Federal statutes and rules. H.R. 6789 follows this same pattern.

In the opinion of the Commission, it is most important that insurance companies be included under H.R. 6789. The Senate has approved this judgment in its passage of S. 1642 and the Commission strongly urges the House of Representatives to do the same.

Mr. Chairman, that concludes the discussion of the insurance phase of this.

(The following document was submitted for the record:)

PRICE FLUCTUATION AND AVAILABLE DATA FOR EVALUATION OF SELECTED INSURANCE COMPANY STOCKS

A group of nonreporting life insurance companies were selected for study on the basis of quotations in the pink sheets. These were not among the very large, well-known companies, but each showed some trading activity. The purpose of the study was to determine the extent to which these companies exhibited price stability. In addition, standard reference works were examined to determine the amount of information available to the average sophisticated investor for use in reaching an informed investment decision. This study showed that the stocks of these companies were volatile and exhibited wide price fluctuations during the period studied and that there was little data available for a sound evaluation of each company.

A sample of 11 companies, based in 10 different States, were selected and the bids in the sheets for a period of 33 months (beginning January 1961) were plotted. Using an index system with January 1962 quotations providing a base of 100, it was found that the prices of these companies fluctuated violently within the period studied. As shown on the accompanying charts, increases and decreases in the order of 50 percent of value were common for the group, with some showing even wider swings. These wide swings were not only on an absolute basis, but also as compared with over-the-counter issues generally as measured by the National Quotation Bureau Price Index.

Research on these stocks was also performed, using those sources generally available to reasonably sophisticated investors. In a search of the SEC's library and files, only 18 references to these companies, including passing mentions in broker-dealer market letters, were found during the 33 months studied—and most of these would be totally inadequate for an investor who was seeking to evaluate the investment merits of the securities.

This review of the information available to the public on the sample revealed the paucity of relevant material. For the majority there was no data in the files of the Commission and only very limited mention in any of the financial publications.

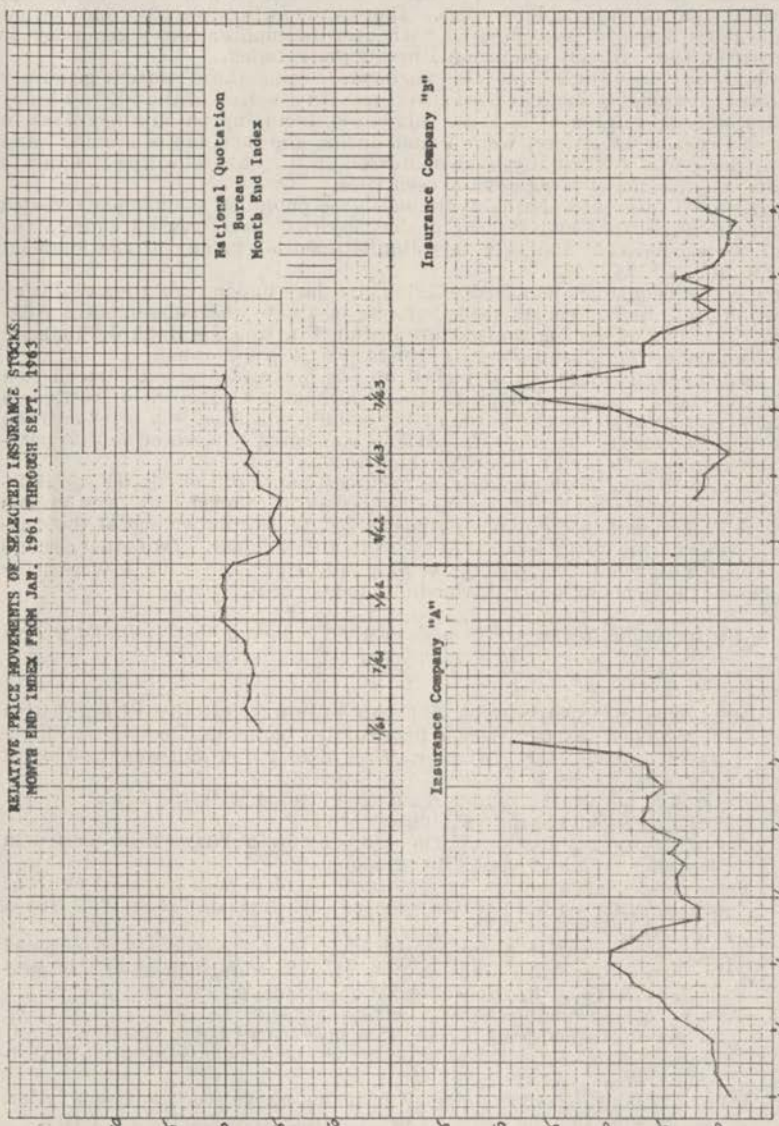
Three of the companies had filed offering circulars under regulation A during the period 1961 to September 1963, but one of these was subsequently withdrawn. Only two of the companies were included in Moody's Bank & Financial Manual and none were mentioned in Standard & Poor's Manual.

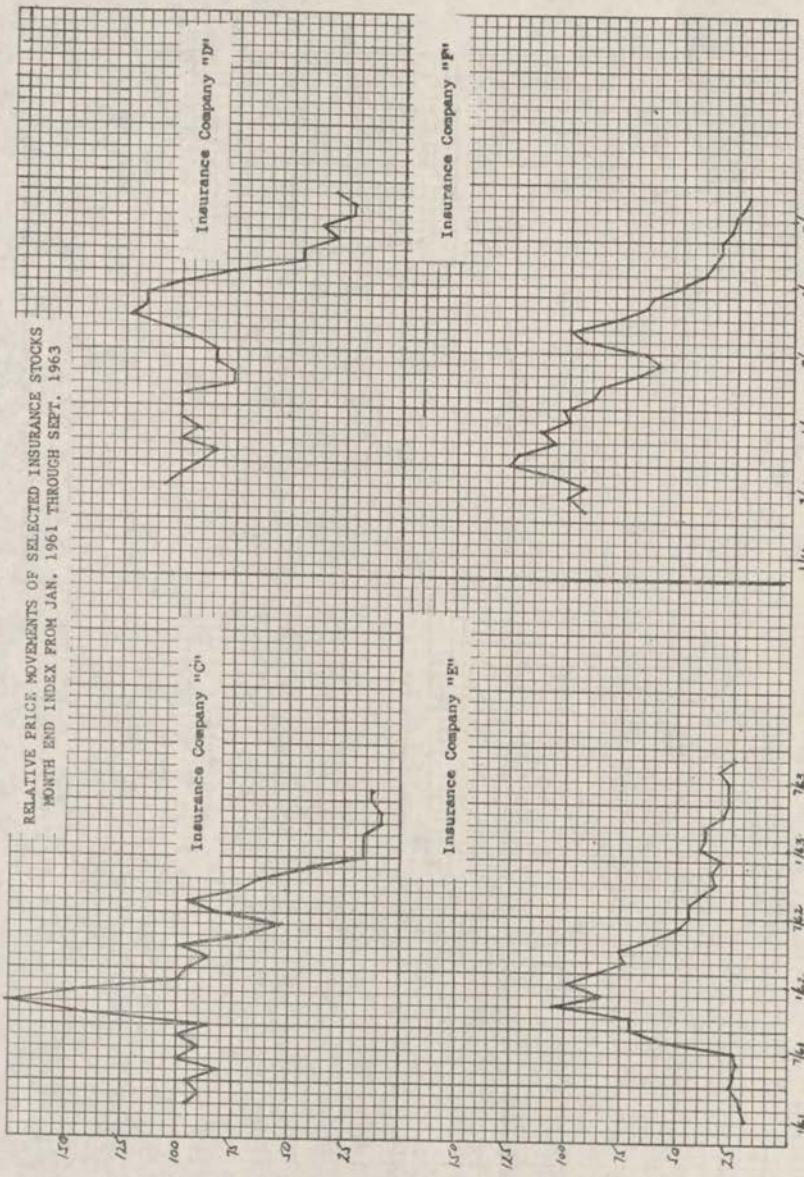
The Investment Dealers Digest picked up one broker-dealer recommendation on one issue and elaborated upon the factors making this stock attractive to investors. Included in another issue of the same publication is a brief mention of one of the issuers to the effect that after a consistent pattern of deficit operations this company showed a profit for the previous year.

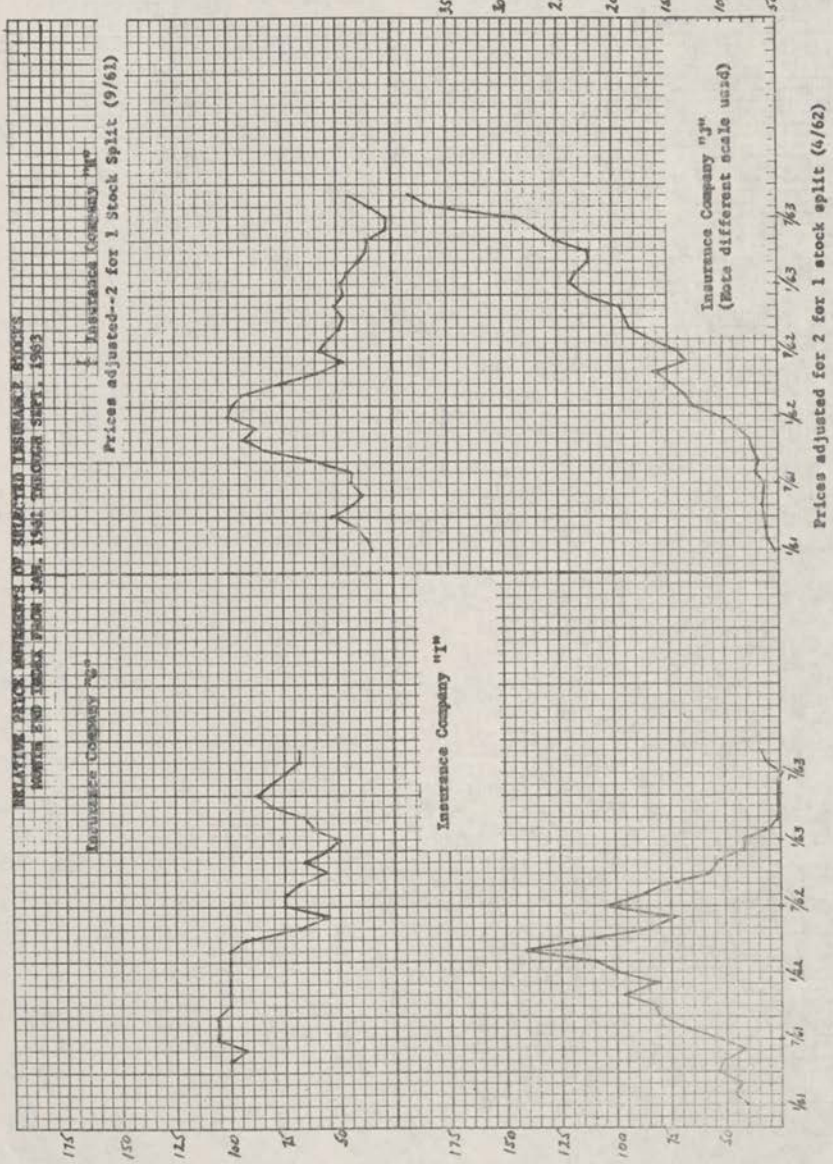
One stock was mentioned annually in an investment advisory letter specializing in insurance stocks; while another issue was mentioned only once in this letter. A brokerage house circular carried a report on another one of the companies. News of one of the issuer's loss was in a newspaper. Two other issuers have been mentioned in various financial publications following proposed acquisitions of the firms by other, larger insurance organizations.

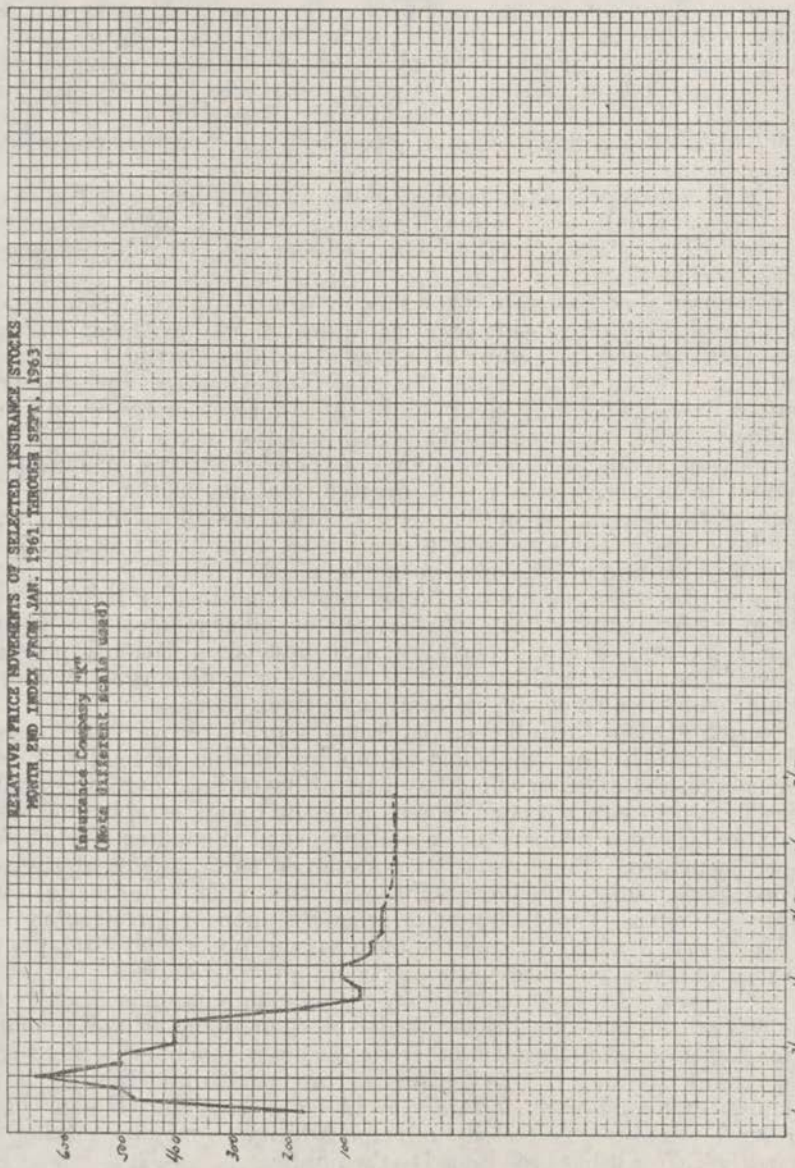
Information available to the public on insurance company stocks, January 1961 to September 1963

Insurance company	
A	Mentioned in Moody's Bank & Finance Manual. Notice of acquisition of the company by a larger firm carried in the Commercial & Financial Chronicle, U.S. Investor, Wall Street Journal, and New York Times.
B	Form 1–A notification under regulation A filed with the SEC.
C	No reference found in the SEC library or files.
D	Notice of the acquisition of the company by a larger firm carried in the Commercial & Financial Chronicle.
E	Form 1–A notification under regulation A filed with the SEC but was subsequently withdrawn. Report of loss during 1962 in Wall Street Journal.
F	Form 1–A notification under regulation A filed with the SEC mentioned in Moody's Bank & Financial Manual. Recommendation of a broker-dealer printed in the Investment Dealers Digest.
G	No reference found in the SEC library or files.
H	Report on the company carried in a brokerages house circular.
I	Brief analysis of the issuer by a broker-dealer was carried in the Investment Dealers Digest.
J	Annual recommendation included in an insurance stock advisory letter.
K	A recommendation included in an insurance stock advisory letter.


RELATIVE PRICE MOVEMENTS OF SELECTED INSURANCE STOCKS
MONTH END INDEX FROM JAN. 1961 THROUGH SEPT. 1963
National Quotation Bureau Month End Index
Insurance Company "A"
Insurance Company "B"
Prices adjusted for 10% stock dividends (1/62 & 1/63)
Prices adjusted for merger (2/63)


RELATIVE PRICE MOVEMENTS OF SELECTED INSURANCE STOCKS
MONTH END INDEX FROM JAN. 1961 THROUGH SEPT. 1963
Insurance Company "D"
Insurance Company "F"
Insurance Company "G"
Insurance Company "E"
150
125
100
75
50
25
1/61
7/61
1/62
7/62
1/63
7/63
Prices adjusted for dividends (6% 8/61 and 5% 12/62)


RELATIVE PRICE MOVEMENTS OF SELECTED INSURANCE STOCKS
MONTH END BIDS FROM JAN. 1961 THROUGH SEPT. 1963
Insurance Company "H"
Insurance Company "I"
Prices adjusted--2 for 1 Stock Split (9/61)
Insurance Company "J"
(Note different scale used)
Prices adjusted for 2 for 1 stock split (6/62)


RELATIVE PRICE MOVEMENTS OF SELECTED INSURANCE STOCKS
MONTH END INDEX FROM JAN. 1961 THROUGH SEPT. 1963
Insurance Company "A"
Other Different Scale Used
600
500
400
300
200
100
1/61
7/61
1/62
7/62
1/63
7/63

Mr. CARY. I would like to go on, if you choose, to the insider trading provisions material.

Mr. STAGGERS. You may proceed.

Mr. CARY. We have thus far focused on the extreme importance of extending basic disclosure principles to the over-the-counter market. Prior proposals to equalize protections between markets have included as a necessary ingredient safeguards against insider trading abuses provided by section 16 of the Exchange Act. This necessity still prevails; accordingly, H.R. 6789 would make section 16 apply to those over-the-counter companies to be covered by the reporting and proxy requirements.

The Commission's experience in administering the securities laws has demonstrated the need for this protection in the over-the-counter market. The analysis of the Report of the Special Study supports this experience.

The absence of adequate disclosure by over-the-counter companies, the difficulties of preventing insider trading misconduct through traditional enforcement procedures, the lack of data concerning the volume and prices of transactions, and the important extent to which insiders control over-the-counter companies—these factors create conditions conducive to insider speculation and manipulation on the basis of information not available to the public. Expanded interest in over-the-counter securities, together with greater volatility in the market for many of these securities in the postwar period, has added to the potential for abuse. The extension of section 16 should have as sound an effect as it has had in the exchange markets.

These provisions, of course, do not prevent an insider from investing in his company's stock. He may buy or sell as much as and whenever he pleases. However, because of his fiduciary relationship to the issuer, he must report his securities transactions, disgorge any short-swing profits, and not sell his company's stock short.

Section 8(b) of the bill exempts from the profit recovery provisions of section 16(b) and the short-selling prohibition of section 16(c) transactions by a dealer which are part of his ordinary trading activities in a company's securities and incident to his establishment or maintenance of a primary or secondary over-the-counter market for those securities. This provision is designed to take care of the so-called sponsorship problem, a point which the industry has made to us.

Mr. DINGELL. Would you define what the sponsorship problem is?

Mr. CARY. I will. I think the next paragraph in part attempts to do so, and if it is not clear perhaps I could go on from there.

As a result of a prior connection with a company, most usually as underwriter, it is claimed that a dealer necessarily undertakes to make a market in its securities—in other words, act as a sponsor. Let's say a company is going to market for the first time, and you may have a single underwriter or certainly a chief underwriter. Under those circumstances he may feel it his responsibility to make a market in that stock after it has been issued to the public.

In other words, since he has sold the shares to X and Y and other persons, somebody is there necessarily to provide a vehicle for purchase and sale of the securities, a market for them. He regards himself, therefore, as a former underwriter, as the sponsor of that stock.

In addition, because of his broad financial experience, he is sometimes sought as a member of the board of directors.

If section 16(b) were applied to marketmaking transactions by broker-dealer directors, they would be compelled to cease their marketmaking activities or resign their directorships.

This director-market-maker issue has been a subject of concern in prior legislative proposals. The report of the Special Study found that this combination involved a little less than 10 percent of all registered broker-dealers and an estimated 13 percent of those over-the-counter securities which evoked some trading interest during a 10-month period examined by the Study.

The Report of the Special Study recommended the general application of section 16 in this area, with exemptive power in the Commission.

H.R. 6789 takes a somewhat different approach and would permit the continuation of the joint function of market maker and director under certain conditions.

Under this section, the Commission would have rulemaking power to prescribe the terms under which securities would be deemed held in an investment account and under which transactions would be considered made in the ordinary course of business incident to the establishment or maintenance of a primary or secondary market.

The Commission would also have power to define each of these terms. The proposed section would avoid the necessity of considering applications for exemption on an ad hoc basis, as recommended by the Special Study Report.

Insofar as broker-dealer insiders are concerned, the Commission has special powers to curb the misuse of inside information. Analysis of the reports which would be furnished pursuant to subsection 16(a) and the periodic inspections of dealers by the Commission's staff will serve as a deterrent.

Moreover, overreaching by the actual abuse of inside information would violate the antifraud provisions of the escurities acts and would be the basis for administrative action against a firm. Thus, we think that providing this exemption with respect to the sponsor, this market-maker exemption, it does not go too far because we still have certain protections and certain, shall we say, controls, over the misuse of this information by persons actually in the securities business.

Mr. Chairman, I will now go to other provisions.

The first two or three I would like to read from the statement. As to the others, I think I will attempt maybe a one-sentence summarization.

Securities issued by foreign companies and certificates of deposits issued against such securities initially would be exempt from the proposed registration requirements for over-the-counter securities. The Commission could terminate the exemption for a class or classes of such securities only upon a finding that they enjoy a substantial public market in the United States and that continued exemption is not in the public interest or consistent with the protection of investors. These procedures would afford interested companies, brokers, dealers, and investors adequate opportunity to bring to the Commission's attention all relevant considerations.

In principle, U.S. investors in foreign securities ought to be afforded the same protections as are provided for investors in domestic securities.

As a practical matter, however, enforcement of the pertinent provisions of H.R. 6789 against foreign companies outside the jurisdiction of the United States would present serious difficulties. Many of these companies have no assets or operations in the United States, have never sought funds in the American capital markets, and have never listed a security on an exchange.

Even in the case of listed securities, where companies voluntarily assume certain obligations, the Commission has found it necessary to provide an exemption from the proxy and insider trading provisions for foreign issuers other than North American and Cuban companies.

Going on from that point, Mr. Chairman, and covering the material which appears in my statement from pages 42 to 50, I would just like to provide a rather brief summary of the additional and perhaps less important provisions from the standpoint of your own views and reactions.

These other important amendments, important to us in the disclosure area, certainly are perhaps not as far reaching as those already discussed.

One is an extension of the 40-day period to 90 days within which prospectuses must be delivered by dealers after a registered public offering. This amendment is a more realistic appraisal of the time during which the distribution process of a security continues in the case of new securities.

Mr. DINGELL. Would you explain just briefly why the need exists for an extension from 40 to 90 days?

Mr. CARY. Yes, sir. I have the material on the bottom of pages 43, 44, and 45 of my statement, Congressman Dingell.

The basic point is, as you may recall, about 2 years ago there was a very large number of so-called hot issues on the market. In those cases the stock was offered to the public, say, at $10 a share, and perhaps the day after or immediately after trading commenced, the market price would shoot up to maybe $20, let's say. That was why is was called a hot issue.

It seemed to use that the people who were in the market for at least a 3-month period after the effective date of the registration statement of that security—although technically not original purchasers—should be treated like original purchasers. They should be entitled to the information contained in a prospectus.

It is for that reason that we wanted to extend the period from a 40-day period to a 3-month period.

The second amendment which is proposed here is that a company which did not solicit proxies must nevertheless furnish stockholders with information that would normally be contained in a proxy statement. As you may know, there are a number of companies—there are even some listed companies——

Mr. KEITH. If you will excuse me, it would help me in following this if you would tell us what pages you are summarizing.

Mr. CARY. Yes, sir. The information with respect to this, Congressman Keith, is at the very bottom of page 45, and for the most part all of page 46.

The situation there is that companies, even presently some listed companies, up until very recently have not solicited proxies in order to avoid the requirements of the proxy statement. Under the rules

of the New York Stock Exchange, you now have to. But, under other rules, you do not necessarily have to solicit proxies if, for example, the management group owns or has enough shares to make a quorum and go ahead and elect its directors.

We think that there should be a provision that, if they don't solicit proxies, nevertheless, information should go out to the shareholders equivalent to what they would get if they did solicit proxies. Thus, all the shareholders, even though not solicited, would secure that information. That is the basic point of that provision.

Mr. KEITH. By and large, do State laws require that minority stockholders get this kind of information?

Mr. CARY. I don't know of any State law that does require it, corporation law, or securities law.

Mr. LOOMIS. I think there is no State that requires this type of information in connection with ordinary elections.

Mr. CARY. The only one that might have possibly would be California, but I don't know of any.

Going on, the third provision or third amendment, at the bottom of page 46 and continuing over to page 47, this is to the effect that any company which goes to the public for funds by means of a registered public offering would thereafter have to file annual and periodic reports with the SEC unless its stockholders were less than 300.

This revision embodies only a minor alteration of present law. Present law provides in general that, if a company goes to the public for funds and the total outstanding shares are equal to $2 million, that company must thereafter file annual and periodic reports. This is a change from the present $2 million figure to one in which we provide that any time there are more than 300 shareholders, and it has gone to the public for funds, it should have to file such information.

A fourth amendment is that any company subject to the reporting requirements would be required to file material contracts not made in the ordinary course of business. That is the middle paragraph on page 47 of my statement.

The fifth amendment, again at page 47, but at the bottom of that page and carrying over to page 48, would permit the Commission to bring an administrative proceeding in order to determine whether a person had failed to comply with the reporting requirements of the Exchange Act in any way. In other words, had filed a false report of some type.

The sixth amendment, which is contained and referred to at page 48 of my statement, would give the Commission certain powers with respect to over-the-counter securities that it now has with respect to listed securities: some powers over proxy solicitation by brokers, where they are holding secuirties in street name; and the power of suspension of trading over a security.

And finally, the last separate amendment which I am now trying to synopsize is referred to at page 49; certain changes would be made in the sections of the Exchange Act permitting unlisted trading. I have attempted to state all of these very briefly; indeed, I do not think they are controversial in nature. They have been hammered out in conjunction with the representatives of the securities industry. As a consequence, I do not think that it would be necessary to go into great oral detail on them with this committee.

I have now completed my statement with respect to really one segment of the bill; namely, that dealing with disclosure and proxy requirements, and the insider trading provisions.

The next part of my statement, Mr. Chairman, starting at page 50, relates to the second part of the bill.

I could, if you chose, answer questions with respect to the disclosure elements of the bill now, or if you wish, I shall go right ahead and finish up the statement.

Mr. STAGGERS. I believe it would be wise to go ahead and finish the statement.

Mr. CARY. All right, sir.

The second major area with which H.R. 6789 deals is qualification standards and controls over those in the securities business. One of the basic purposes of the Securities Exchange Act of 1934 is to regulate conduct of brokerage firms and persons associated with them, both through direct SEC controls and through self-regulation, with appropriate Commission oversight.

The vast growth in the securities markets has been accompanied by a rapid increase in the number of securities firms and their employees. For example, the membership in the National Association of Securities Dealers, the self-regulatory agency for the over-the-counter market, has more than doubled since 1945. Over the same period, registered representatives have increased from about 25,000 to 95,000, and branch offices of members from 790 to 4,713.

This expansion, accompanied by a comparable growth in securities traded and in the number of investors, has strained the regulatory pattern of the Securities Acts and emphasized the dramatic need for stronger and more refined controls. Accordingly, the Commission recommends the enactment of a series of proposals, contained in sections 2, 6, and 7 of the bill, designed to enlarge the scope of self-regulation, to raise the standards for entry into the securities business, to refine Commission disciplinary controls over brokers, dealers, and their employees, and to clarify and improve existing provisions dealing with related matters.

The controls provided would have their primary impact upon those who deal in over-the-counter securities and would complement the protections recommended with respect to companies whose securities are traded in that market. At the hearings on S. 1642, these provisions had the strong support of major groups in the securities industry, including the NASD, which would have important responsibilities under them.

I would like to summarize present law as compared with proposed amendments.

Control over over-the-counter brokers and dealers begins with the requirement that they register with the Commission. That is present law. Section 15 of the Exchange Act provides for revocation or denial of registration if a firm, or any person associated with it, (1) has been convicted of a crime involving securities transactions or the securities business; (2) is enjoined from engaging in any act or practice in connection with securities transactions; or (3) has willfully violated the Securities Act or the Exchange Act.

Section 15A of the Exchange Act authorizes registration with the Commission of national securities associations. These organizations

of over-the-counter brokers and dealers were intended to provide a medium for self-regulation for the over-the-counter market comparable to the securities exchanges in the listed market.

Section 15A contains rather detailed provisions concerning the rules, organization, and disciplinary proceedings of such associations and gives the Commission a certain amount of regulatory power over them. At present, only one association, the NASD, has registered, and the great majority of over-the-counter firms are members.

Against this background of existing law, the principal proposed changes are as follows:

First. All over-the-counter broker or dealer firms would be required to be members of a registered securities association.

Second. Registered securities associations would be required to adopt rules establishing standards of training, experience, and competence for members and their employees and to establish capital requirements for members. The Commission's powers to change the rules of an association would be expanded to include these rules.

Third. In a disciplinary action, the Commission could proceed directly against an employee of a broker or dealer in lieu of proceeding against the entire firm, and the authority of a national securities association to do the same would be clarified. The Commission could also impose sanctions short of revoking registration, such as a temporary suspension or censure.

Fourth. Certain other changes are proposed, including: a slight broadening of the category of crimes, injunctions, acts, or omissions that afford a basis for disciplinary proceedings by the Commission. In the case of brokers and dealers registered with the Commission, the necessity for proving that the mails or instrumentalities of interstate or foreign commerce were used in a particular proscribed transaction would be eliminated. Also, the exemption from the registration for brokers or dealers whose business is "exclusively intrastate," but who use the mails or any instrumentality of interstate or foreign commerce, would be repealed. Finally, certain other limited changes in existing laws would be made.

B. REQUIREMENT OF MEMBERSHIP IN A SELF-REGULATORY AGENCY

Self-regulation by industry organizations under the supervision of the Commission provides a significant dimension to regulation of the securities markets. This concept of self-regulation is evident in section 6 of the Exchange Act which imposes a duty upon exchanges to establish and enforce rules of fair dealing for their members. It was notably reaffirmed in 1938 when Congress enacted section 15A, the Maloney Act, and authorized a similar regulatory pattern for the over-the-counter market. The Commission has agreed with the report of the study 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 important reliance on self-regulation rests on two principal premises: First, self-regulation provides an alternative to more pervasive direct control by Government, which would be expensive to the taxpayers and burdensome to the industry.

Second, it can be a more sensitive means for developing high standards of business conduct. While self-regulation has significantly contributed to investor protection, the Report of the Special Study recommended—and the Commission strongly agrees—that the responsibilities of the self-regulatory agencies should be substantially expanded and made more effective in various areas. These recommendations envisage a more important role for self-regulation in establishing standards for investor protection. To be truly effective, these standards must be observed uniformly throughout the industry or there will be a void which could be filled only by Commission action.

This is sharply illustrated by the Commission's recommendation in H.R. 6789 for standards of qualification for those in the securities business, to be established and administered by the self-regulatory agencies. In a qualification system which contemplates the complementary efforts of Government and industry, all groups subject to Government controls should also be subject to industry controls, either through the NASD or through similar organizations. In the light of these considerations, it would not be in the public interest to permit any broker or dealer, at his option, to exempt himself from the structure of self-regulation and its corresponding controls simply by choosing not to join a self-regulatory agency. Accordingly, section 6(a) of the bill would require all brokers and dealers to join such an agency, subject to a power in the Commission to grant exemptions where necessary and appropriate.

At the present time, membership in the NASD is primarily based on the economic inducements authorized by section 15A(i) of the Exchange Act that no member shall deal with a nonmember broker or dealer except at the same prices and upon the same terms as such member deals with the public. A practical effect of this provision, and the corresponding NASD bylaws, is that nonmembers cannot obtain underwriting discounts in distributions by members or other possible benefits in trading with them.

Consequently, most over-the-counter brokers and dealers find it economically necessary to be members of the NASD. A limited number, however, restrict their operations to retailing directly to the public securities of companies with which they have some association—for example, as the sole underwriter. It is important that this group, which includes retailers of mutual fund shares and real estate securities, be brought within the self-regulatory scheme.

A Special Study analysis as of February 28, 1962, indicated that 1035 of the 5785 registered brokers and dealers were not members of the NASD. Of these, approximately 40 percent were either new firms who had not yet commenced business, or existing firms which had gone out of business but had not withdrawn their registrations. About 9 percent were exchange members who presumably do a very limited over-the-counter business. Approximately 20 percent were engaged primarily in real estate, oil royalties, savings and loan shares, insurance, and the like.

Many in the above two categories would probably qualify for exemption under the Commission's rulemaking power. The remaining firms, about 300, would be the principal subjects of this amendment. It should be made clear that certain of these are very substantial organizations. For example, 2 mutual fund distributors have selling forces of 7,500 and 3,200.

No industry organization, nor trade association, has objected to the requirement of compulsory membership. Indeed, it is significant that the Association of Mutual Plan Sponsors, which includes among its membership an important segment of those dealers who are not members of the NASD, supported the notion that the principle of self-regulation should be extended to all members of their industry.

Registered securities associations are not private clubs. They are organized under statutory authority to perform under governmental oversight regulatory functions in the over-the-counter market. The requirement of membership in a registered securities association should raise no questions of lack of due process or excessively broad delegation of powers in view of the extent of governmental oversight.

For example, the Commission can direct that a broker-dealer be admitted to membership. Any new rule proposed to be adopted by an association must be approved by the Commission and any existing rule can be abrogated by it. All disciplinary actions are subject to review by the Commission, and to further review by an appropriate U.S. Court of Appeals.

I think under those circumstances, the constitutionality question which has been raised by several letters that I have received is clearly resolved.

Finally, it should be pointed out that the Exchange Act contemplates that national securities associations, other than the NASD, can appropriately be formed. It is necessary that the Commission find that the size, scope of transactions, geographical distribution of the membership, and organization of the association are of such a character as to enable it to comply with the provisions of the act and to carry out the purposes of the section.

In addition, Congress has explicitly declared that registration as a national securities association is to be limited to organizations which are "a proper subject of national concern." If a group of responsible dealers who meet these standards should wish to form and register a national securities association, the Commission would in no way obstruct its registration. On the contrary, we would be glad to assist in achieving compliance with the requirements of the act.

C. STANDARDS OF QUALIFICATION

The Exchange Act presently embodies the concept that anyone, regardless of fitness, competence, or capability, may enter into the securities business and assume any role in that business, unless he has been found guilty of recent securities violations. The Report of the Special Study confirms the Commission's belief that this concept is obsolete and no longer in the public interest.

The steady growth in the number of investors, the complex nature of the securities markets, the reliance which the investing public necessarily places upon the competence and character of professionals in those markets, all of these factors militate against permitting the incompetent and unqualified to enter the industry. These conditions subject the public to undue hazards and unnecessarily complicate the task of regulation.

The hazards are illustrated in an analysis by the Special Study of violations committed by securities firms. Almost 28 percent of new firms registering with the Commission during the first 3 months of

1961 had no experienced persons among their principals—proprietors, partners, officers, and large stockholders—and over 50 percent of the firms were in the hands of persons with under 2 years of experience.

Further examination disclosed that the newest member firms of the NASD, which are generally controlled by persons having less experience than principals of older firms, were responsible for a heavy preponderance of the offenses drawing the most severe penalties in disciplinary actions. These offenses often appeared to be attributable to their principals' lack of familiarity with the technical and financial aspects of the business.

Certain of the major exchanges, particularly the New York Stock Exchange, have taken the initiative in this area and established standards of competence, experience, character, and capital. These, however, have only a restricted impact, because of the selective nature of exchange membership. The void in the over-the-counter market has only been partially filled by the NASD.

The Commission believes that the self-regulatory agencies, under its supervision, are particularly equipped to develop and administer qualification standards for those in the securities business. Accordingly, it is recommended in section 7(a)(3) of the bill that responsibility be given to the NASD for the establishment of such standards, including those relating to training and experience for its members and their employees, and capital requirements for members. In this manner, all persons dealing in over-the-counter securities would have to meet certain basic requirements, which could vary with the responsibilities of the job; thus, branch office managers would have to meet higher tests of experience than salesmen.

In establishing criteria, the NASD could adopt appropriate "grandfather" clauses exempting existing members or their employees, either permanently or for a transition period, from some or all of the qualifications required of new entrants. The Commission would have to approve these standards and could change them if in the public interest. At the same time, it should be emphasized that no national securities exchange which desires to set standards for its members higher than those prevailing in the over-the-counter market would be prevented or discouraged from doing so.

The Commission believes that the establishment of qualification standards, in conjunction with the requirement of membership in a a self-regulatory body, will measurably simplify regulation and improve investor protection. Enactment of these provisions will result in better qualified persons rather than more policemen.

As a supplement to strengthening entrance requirements through the medium of the self-regulatory agencies, the Federal bases for disqualification of brokers and dealers would be expanded to a limited extent by section 6(b) of the bill, so as to conform with the provisions recently approved by the Congress in the 1960 amendments to the Investment Advisers Act of 1940. These new disabilities would include not only offenses and injunctions involving securities transactions or the securities business, but would also cover other types of financial offenses which equally reflect upon a person's suitability to handle other people's money.

In addition, the bill would make a failure reasonably to supervise employees a basis for disciplinary action against a broker or dealer

or supervisor. The Commission has consistently held that brokerage firms and their principals have a duty to supervise and on numerous occasions has stressed the necessity for adequate supervision as an essential key to maintaining proper standards.

The report of the Special Study documented the damage that can result to investors from its absence, particularly in the case of a large firm with branch offices scattered throughout the country. The proposed amendment will make this important supervisory responsibility explicit on the face of the statute and set express guidelines for its fulfillment. This codification becomes more important in view of the proposed authority for the Commission to proceed directly against individuals.

D. COMMISSION DISCIPLINARY CONTROLS OVER BROKERS AND DEALERS

The Report of the Special Study pointed out the rigidity and artificiality of the present statutory scheme for disciplining violators, in neither providing for direct action against individual wrongdoers, nor expressly authorizing useful intermediate sanctions against a firm short of revoking registration. Section 6(b) of the bill would add needed flexibility to the Commission's disciplinary powers to overcome these limitations.

At the present time, if an individual connected with a securities firm violates the law without the approval—or the knowledge—of his employer, the Commission can take disciplinary action only by a proceeding against the entire firm. This approach, possibly involving many persons wholly innocent of the violations in question, is awkward and may be unfair. For this reason, individuals may sometimes not be properly disciplined.

Accordingly, section 6(b)(3) would permit the Commission to act directly against offending individuals, where that course is appropriate, in lieu of proceeding against the entire firm. The power of the NASD so to act would also be clarified. Of course, this section would not in any way reduce the responsibility of a firm to supervise its employees, an obligation expressly recognized, as already discussed, in the bill.

Section 6(b) would also provide needed flexibility by authorizing the Commission to impose sanctions intermediate to putting a firm out of busness. Short of such revocation, the Commission could temporarily suspend or censure. At present, the Commission has only three alternatives: It may revoke registration and expel a firm from any exchange or association of which it is a member; it may, at the other extreme, impose no sanction at all; the only intermediate sanction is a suspension of membership in the NASD or an exchange if the firm happens to be a member.

The effectiveness of a suspension from an exchange or the NASD as a meaningful sanction varies considerably in accordance with a firm's business and its reliance for profits upon professional price concessions from members of an exchange or securities association.

Another aspect of present law which dilutes the effectiveness of Commission regulation is the exemption from registration for brokers and dealers doing an exclusively intrastate business but who use the mails or instrumentalities of interstate commerce to effect purchases

and sales. This narrow exemption from registration would be eliminated by section 6(a) of the bill.

To qualify for the exemption, a broker must deal not only with customers who are exclusively within a State, but he must deal exclusively in securities originating in the State. Information obtained in the course of investigations indicates that intrastate brokers and dealers quite frequently overstep these restrictions and thus involve themselves in inadvertent—or willful—violations of Federal laws. There are several reasons why the Commission believes this exemption should be eliminated.

First, the Congress has imposed upon the Commission statutory responsibility for the conduct of these intrastate brokers and dealers in various important respects, including the enforcement of the antifraud provisions and the financial responsibility requirements of the Exchange Act. However, the Commission lacks adequate means to discharge these responsibilities, since it does not learn of the existence of these brokers except as a result of a complaint and, furthermore, it has no authority to require them to keep books and records.

This leads to the anomalous result, for example, that intrastate firms are subject to the capital requirements prescribed under the statute, but are not required to keep any records as to how much capital they have. As a result of these handicaps, the Commission must devote an amount of time and effort to fraud investigations involving intrastate broker-dealers that is out of proportion to their number and importance.

In that connection, I just happened to have brought to my attention an article in the Wall Street Journal of June 14, 1963, which I would like to ask have go into the record. It deals with Indiana alone and it says, "Indiana Fears Scandal in Intrastate Stocks," and "SEC Seeks Reforms." It says:

> "Frankly, I'm holding my breath until I get out of office, for fear there will be a major scandal in the Indiana securities markets."
>
> The speaker is the tall distinguished looking Charles O. Hendricks, who, as Indiana secretary of State, will remain responsible for the State's securities department until his term ends on November 30, 1964.

He points out here that:

> Although stocks and dealers are subject to policing by the State, many reputable brokers contend that the regulatory system in Indiana, like some in other States, is woefully inadequate. Moreover, these critics point out that most dealers specializing in intrastate stocks don't belong to the NASD, and thus escape disciplines imposed by this watchdog of over-the-counter trading.

They give examples of situations that have occurred in that particular State. I think this is symptomatic of some of the problems that we have under our general antifraud provisions with respect even to intrastate brokers and dealers at the present time when we don't have the means and facilities to deal with them at the present time.

Mr. STAGGERS. Without objection, the statement will be included in the record.

(The document referred to follows:)

[From the Wall Street Journal, June 14, 1963]

INDIANA FEARS SCANDAL IN INTRASTATE STOCKS; SEC SEEKS REFORMS

GLIB DEALERS DECEIVE INVESTORS; REPUTABLE BROKERS COMPLAIN REGULATION BY STATE IS WEAK

(By Kenneth G. Slocum, staff reporter of the Wall Street Journal)

INDIANAPOLIS.—"Frankly, I'm holding my breath until I get out of office, for fear there will be a major scandal in the Indiana securities market."

The speaker is tall, distinguished-looking Charles O. Hendricks, who as Indiana secretary of State will remain responsible for the State's securities department until his term ends on November 30, 1964. His statement reflects growing concern over a securities problem, the significance of which reaches well beyond the banks of the Wabash.

The problem involves alleged fraudulent transactions in intrastate securities. These are over-the-counter stocks issued and distributed solely within a State; as such, these securities, and broker-dealers who handle them exclusively, now are exempt from registration with the Federal Securities and Exchange Commission.

Although such stocks and dealers are subject to policing by the State, many reputable brokers contend that the regulatory system in Indiana, like some in other States, is woefully inadequate. Moreover, these critics point out that most dealers specializing in intrastate stocks don't belong to the National Association of Securities Dealers (NASD), and thus escape disciplines imposed by this watchdog of over-the-counter trading.

Proposed reforms

To help remedy such situations, the SEC last week submitted to Congress, among other proposed reforms, a recommendation that would in effect eliminate the exemption from registration for most intrastate dealers. The SEC also proposed that all such dealers be required to belong to the NASD, or some other self-regulatory agency. Meanwhile, SEC agents have been active in Indiana, investigating, claims of some companies to intrastate exemptions for their stocks.

Intrastate stocks, for the most part, are issued by companies just getting into business. Major securities houses usually won't underwrite a company's stock issue until it has a record of several years of earnings. So small brokers often handle the issue on a "best efforts" basis, that is, the company gets its money as the stock is sold, instead of in one lump sum as underwriters traditionally handle it.

Major Indiana broker-dealers have no quarrel with the principle of these high-risk, intrastate stock issues or those ethical brokers who specialize in them. "The country was built on such speculative investments," one observes. But they say most intrastate stocks are so thinly traded it's often difficult or impossible to determine the going price. This enables some unscrupulous dealers to buy stocks cheaply and sell them at high prices to unsuspecting customers.

A manager of a big Indianapolis securities house says, "As true as I sit here, this sort of thing happens at least once a week: A downstate banker called me to say a client was about to make a sizable investment in an Indianapolis company at $4 a share. But when I ran it down it was bid at 25 cents." Few persons investing in the speculative issues bother to check with bankers or other brokers, he said.

"Cases of deceit"

"We hear of pitiful cases of securities deceit almost every day," says Noble Biddinger, president of City Securities Corp., Indianapolis, and a member of a committee of Indianapolis brokers formed recently to combat the situation. "While all of us consider venture capital necessary, we don't think widows, orphans, and thrifty old ladies should be fast talked into putting their savings into them under the guise they are safe investments." He notes that any reflection on the securities industry affects all dealers.

Lehman Sadler, an Indianapolis attorney who was a State securities commissioner in 1959–60, cites the recent case of a widow who had been left a $22,000 investment in a mutual fund and almost no other income. A roving securities salesman persuaded her to take her money out of the mutual fund and put it in the intrastate stock of a small insurance company. His major pitch was personal assurance that the stock, bought at $1.50 a share (about 25 cents above the going price) would climb to $2 in 6 months. Instead it dived to near $1.

The salesman, confronted with the complaint about his deceptive sales pitch and the fact he had no State securities license, paid back the widow's loss, Mr. Sadler says. Few victims are so lucky, he notes.

Such issues and dealers are not major problems in States, such as California and Illinois, that have strong securities departments and regulations that often are tighter than the SEC's. But both Mr. Sadler, a Democrat, and Secretary of State Hendricks, a Republican, agree that the Indiana Securities Department's shortage of funds and experienced personnel leaves the door open to irregularities.

The present Indiana securities commissioner is Martin K. Edwards, 25, a part-time law student, who draws an annual salary of $7,200. He has two investigators, paid $375 a month, who have little pertinent experience. All jobs are controlled by political patronage and usually last 2 years at the most.

"I'm the first to admit my job demands a veteran, top flight attorney," says Mr. Edwards. "We're doing the best we can with what we have."

"What we need are two competent and permanent auditors who can make surprise audits in the field and discern suspicious entries in routine financial reports," says Mr. Hendricks. Indiana legislators failed to approve a recent request to double the securities department's annual budget of $57,000. Currently almost any person can become a securities salesman in Indiana for a $5 fee and a routine credit check, a situation Mr. Edwards is seeking to correct with a proposed entrance examination.

Purporting to fill the policing gap is a new group, the Indiana Broker-Dealer Association, comprised of 28 broker-dealers who specialize in buying and selling intrastate stocks. "We'll kick them out and order members not to buy from them," says the group's president, Walter E. Holt, explaining how it would discipline errant members.

But a considerable segment of the financial community looks askance at the organization. While the NASD is taking no formal position on the group, it has ordered its public relations counsel, Conway & Associates, Chicago, to direct its Hoosier members in resisting the new organization.

Says Frank L. Reissner, former chairman of the NASD Board of Governors and president of the Indianapolis Bond & Share Corp.: "By claiming that they can do the same policing job for intrastate brokers as NASD does nationally, this organization can delude the public into thinking the situation is under control."

SEC activity in Indiana has resulted in injunctions preventing some companies from distributing more stock until they file a full registration with the SEC. These injunctions have been granted on the ground that the companies violated some aspect of the intrastate exemption requirements. Some companies, for example, distributed their stock outside the State.

Mr. CARY. Secondly, these intrastate firms are wholly outside the scope of the pattern of self-regulation, which is otherwise such a significant part of the statutory scheme. Unless the present exemption is deleted from the statute, the enactment of H.R. 6789 will result in the establishment of minimum standards of qualification for all broker-dealers except those in the intrastate category.

Thirdly, when an intrastate broker-dealer restricts himself to the permissible area contemplated by the exemption, he is strictly limited in the securities which he may recommend and sell to his customers. For example, he may not be able to deal in any securities listed on the New York Stock Exchange. It is unfortunate that any broker-dealer is so limited since the very securities that he cannot recommend might be those most suitable for his customers.

Finally, if the Commission suspends broker-dealer registration for a limited period, a firm should not be able to minimize the impact

of this suspension by conducting an exclusively intrastate business during the period specified.

The only feasible way to manage these problems is to require registration of those intrastate broker-dealers who use the instrumentalities of interstate commerce in their business. Registration will allow the Commission to discharge the obligations already imposed upon it by the Congress.

At the same time, it should be made perfectly clear that the repeal of this exemption in no way interferes with the States' regulation of broker-dealers. Section 28(a) of the Exchange Act explicitly reserves State jurisdiction in these areas and this philosophy should and would apply to the intrastate broker-dealers—as it does to interstate broker-dealers.

Section 6(b) would dispense with proof of the use of the mails or interstate facilities in the case of Exchange Act violations by federally registered brokers or dealers. I want to emphasize that the primary purpose of this change is not to expand our jurisdiction over registered broker-dealers, which is already comprehensive, but rather to relieve our enforcement staff from the essentially useless task of collecting envelopes or other evidences of the use of the mails or interstate facilities in connection with particular transactions. The amendment will thus enable us to use our resources more productively and eliminate unnecessary expense to the taxpayers.

The use of the mails or facilities of interstate commerce has been viewed by the Congress as a basis for requiring registration by broker-dealers with the Federal Government. Once registration has been effected, there is no constitutional necessity or little good reason why the Commission's power to discipline broker-dealers for violations of the securities laws should depend upon the fact that Federal instrumentalities were utilized in the particular unlawful transactions.

There are numerous precedents for this position in the securities acts, including sections 7, 8, and 16(b) of the Exchange Act. It should here be emphasized that dispensing with technical proof of jurisdiction in connection with particular transactions does not affect reliance on the interstate commerce clause as the basis for Federal registration of broker-dealers. Registration would be required only if a broker-dealer makes use of interstate facilities.

Section 6(b) will not place the Commission much further into the regulation of intrastate transactions of registered broker-dealers than it already is. Various general regulations of the conduct of the business, such as the bookkeeping rules, the margin rules, and, as a practical matter, the capital rules apply whether particular transactions are interstate or intrastate, and whether or not the mails or interstate instrumentalities are used in them.

Members of exchanges are subject to certain provisions merely because of their status, as such. Any transaction on an exchange is subject to Commission jurisdiction, even if all of the parties reside in the same State, since a national securities exchange is itself a facility of interstate commerce. More significantly, any use of the mails invokes our jurisdiction, even if the addressee lives across the street. Broker-dealers use the mails in most of their transactions, local or otherwise, if only to send out confirmations, and the great bulk of their

activities thus come within our jurisdiction. Thus, as I stated, the primary effect of the amendment is to relieve us of the burden of collecting evidence, finding envelopes.

E. AMENDMENTS WITH RESPECT TO REGISTERED SECURITIES ASSOCIATIONS

In addition to those fundamental amendments already discussed which concern the NASD—required membership in a self-regulatory agency and the establishment of qualification standards—the Commission is also recommending a series of proposals designed in a few respects to clarify or strengthen present law with respect to self-regulatory associations.

First, an increasing scope for responsibility by the NASD is reflected in section 7(a)(6) requiring its adoption of rules designed to produce fair and informative quotations of over-the-counter securities. The section is intended to clarify the NASD's authority in this area and further to impose upon it a responsibility to act. It is not a resolution of the problems affecting over-the-counter quotations, but a means for dealing with some of these problems.

Secondly, section 7(c) would shorten from 60 to 30 days the time for appealing to the Commission from disciplinary action taken by the NASD or its denial of membership. This reduction will expedite Commission review proceedings and still allow ample time for appeals. This section also provides that the Commission may order, after a hearing, that an appeal from an NASD disciplinary action will not stay the judgment of the NASD pending final decision on review by the Commission. At present, an appeal automatically operates as a stay.

It is contemplated that this new power to lift the stay would be sparingly employed; however, its use would be proper where an appeal is clearly taken for delay, and injury to the public should be prevented pending Commission action.

Finally, under section 7(a)(1), the NASD would be authorized to adopt rules, subject to Commission approval, which would permit exclusion from its membership of persons who have been suspended or expelled from an exchange for violation of any exchange rules. It is anticipated that only serious misconduct of a nature affecting the protection of investors would be grounds for exclusion and any such action would be subject to Commission review. This section would resolve a problem existing primarily between the NASD and the New York Stock Exchange with regard to the collateral effects of the latter's disciplinary proceedings.

In concluding, I would again note that H.R. 6789 is in response to a congressional directive, originating in this committee, to the Commission to evaluate the adequacies of prevent investor protection. That directive has produced a searching and intensive inquiry by the Commission's Special Study of Securities Markets. It also resulted in a firm conviction on the part of the Commission that the present statutory structure of the securities acts requires improvement in significant respects. The provisions of H.R. 6789 represent such a strengthening and the Commission strongly recommends its enactment.

I appreciate yours indulgence in listening to this very long statement. I have attempted to put in a considerable amount of material on the basis of questions that we have received, and I know that you have received, with respect to this bill over the last few months.

(Mr. Cary's complete statement follows:)

STATEMENT OF WILLIAM L. CARY, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

Mr. Chairman and members of the committee, I am William L. Cary, Chairman of the Securities and Exchange Commission. I am accompanied today by my fellow Commissioners and by certain members of the Commission's staff.

I.

We are here today to testify on H.R. 6789, 6793, and S. 1642. These bills embody legislative recommendations of the Securities and Exchange Commission. H.R. 6789 and 6793 are identical and were introduced by Congressmen Harris and Staggers, respectively. S. 1642, which passed the Senate on July 30, 1963, differs only in very limited aspects from its House counterparts. For convenience, I shall discuss the bills in terms of H.R. 6789. I would like to emphasize that the Commission accepts and supports all of the amendments made by the Senate bill.

H.R. 6789, an amendment to the Securities Exchange Act of 1934 and—in one respect—to the Securities Act of 1933, is designed to deal with areas where the present statutory structure of the securities acts is inadequate and vitally in need of strengthening. In the unanimous opinion of the Commission, the enactment of H.R. 6789 will represent a major achievement in securities regulation by materially increasing existing investor protection and thus maintaining and enhancing investor confidence.

This bill on which we are testifying today is a most important consequence of the Report of the Special Study of Securities Markets, which was authorized and directed by the Congress in Public Law 87–196. The study originated in this committee in the form of House Joint Resolution 438 and was a product of congressional belief that the scheme of securities regulation needed a thorough reevaluation after a 25-year period of tremendous growth in the securities markets and important changes in market practices. Pursuant to the congressional directive, the Commission's Special Study of Securities Markets engaged in a broad and intensive analysis of the securities markets. The final segment of the Report of the Special Study, reflecting that examination, was delivered to Congress on August 8, 1963. The proposed amendments contained in H.R. 6789 are in substantial part based upon, and supported by, that report.

In its broadest terms, H.R. 6789 has two major purposes. The first is to improve investor protection in the over-the-counter market, primarily by extending fundamental disclosure requirements. Disclosures now furnished by listed companies would be required also of companies whose securities are traded in the over-the-counter market and in which there is a substantial public interest. The second major purpose is to strengthen qualification standards and controls over those in the securities business, again with emphasis on the over-the-counter market. We stress that these purposes are interrelated and have a common goal—the raising of standards in the securities markets. Basic and reliable corporate information, essential for informed investing, is a necessary adjunct to higher qualifications for those who deal in over-the-counter securities. Improved standards in the securities markets are best assured by the combination of better information about securities, on the one hand, and better qualified persons to utilize and evaluate that information, on the other. Each proposal in H.R. 6789 would be an important advance; but it is the sum of all of them which will produce the maximum benefit in the public interest.

II

I would first like to discuss those sections of the bill dealing with improved and expanded disclosure for over-the-counter securities.

A. OUTLINE OF PROVISIONS WITH RESPECT TO THE EXTENSION OF DISCLOSURE REQUIREMENTS TO OVER-THE-COUNTER COMPANIES

H.R. 6789 would extend to investors in over-the-counter securities the fundamental protections now generally afforded by the Securities Exchange Act of 1934 only to investors in securities listed on an exchange. These protections may be briefly described as follows:

(1) Under sections 12 and 13 of the Exchange Act, a company which lists its securities on an exchange must file a registration statement containing material financial and business information concerning its operations. This information must be kept current by annual and periodic reports. With the exception of information accorded confidential treatment, all materials so filed are available for inspection by the public and copies can be obtained from the Commission upon payment of a reproduction fee.

(2) Pursuant to section 14 of the Exchange Act, security holders whose votes are solicited by corporate management, or others, must be furnished with a proxy statement. This statement must contain adequate and accurate information so that the corporate franchise may be intelligently exercised.

(3) Under section 16 of the Exchange Act, corporate "insiders," i.e., officers, directors and 10-percent stockholders, are restricted in their use of inside information for personal benefit. These insiders must report their securities transactions; the corporation may recover their trading profits made within a 6-month period; and they are not allowed to sell short.

All of these protections are now available in the over-the-counter market only to investors in securities of public utility holding company systems and closed-end investment companies. In addition, by virtue of section 15(d) of the Exchange Act, the reporting requirements do apply to over-the-counter companies, presently about 2,400 in number, that register a public offering of securities with the Commission and the value of the class of securities offered and outstanding is over $2 million. Investors in all other companies do not receive the benefits of these protections.

Sections 3, 4, 5, and 8 of H.R. 6789 will make these fundamental safeguards applicable to the over-the-counter market. Initially companies having more than $1 million in assets and a class of equity securities held of record by 750 or more persons would be required to register with the Commission and assume the obligations of listed companies. After 2 years, or a longer period if the Commission so determines, the stockholder requirement would drop to 500. These 2 standards would result in an estimated additional coverage of 3,100 and 3,900 companies, respectively. In the case of banks the bill contemplates that the functions of the Commission would be administered by the appropriate Federal banking regulatory agency upon its request. (Under the Senate bill, jurisdiction would vest directly in the banking agencies.)

These provisions would not apply to foreign companies, unless the Commission finds any such company, or class of companies, should be included because of an active trading market in the United States. Moreover, dealers who make markets in over-the-counter securities would be exempted from the insider trading section to the extent of their market-making activities, but subject to terms and conditions to be prescribed by Commission rules. Finally, the Commission would have broad powers to exempt issuers, affected persons, and securities.

The policy supporting this expansion of the basic disclosure philosophy of the securities acts into the over-the-counter market has long been recognized; so has the need. Both have been strongly confirmed by the Report of the Special Study, which contains a detailed analysis and statistical survey of the problem in chapter IX. The securities industry and other important groups have indicated their agreement that these disclosure protections are needed. In fact, in the Senate hearings on S. 1642, there was general support for the extension of these provisions to over-the-counter companies; the most significant question raised concerned the coverage of companies in certain fields—primarily banks and insurance companies.

B. THE BASIC DISCLOSURE PHILOSOPHY OF THE SECURITIES ACTS

The keystone of the entire structure of Federal securities legislation is disclosure. Making available to investors adequate financial and other information about securities is the best means of enabling them to make intelligent investment decisions and of protecting them against securities frauds. Thus, the House Committee on Interstate and Foreign Commerce, in its report accompanying the Securities Exchange Act of 1934, stated:

"No investor, no speculator, can safely buy and sell securities upon the exchange without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indexes of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of powerful groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges. Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet." (House of Representative Rept. No. 1383, 73d Cong., 2d sess. (1934) 5, 11–12.)

Although the quoted statement singles out the exchanges, it applies to all securities, listed or unlisted. Because too little was known about the over-the-counter market in 1934 to enable Congress feasibly to devise provisions as specific as those relating to listed securities, the original section 15 of the Exchange Act granted the Commission rulemaking power in relation to the over-the-counter market. In doing so the expressed purpose of Congress was "to insure" investors in over-the-counter securities "protection comparable" to that provided investors in listed securities. The sanctions made available, however, proved inadequate because of their focus upon brokers and dealers, rather than companies, and the provision was repealed.

There is no convincing reason why the comprehensive scheme of disclosure that benefits the exchange markets should not also apply in the over-the-counter market. Nothing in the nature of the securities traded in that market or in its mechanics makes any less necessary the disclosure of basic information about its companies. On the contrary, because the over-the-counter market includes not only widely known and seasoned companies, but also relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great as, if not greater than, in the exchange markets. The over-the-counter market has become a significant institution in channeling the flow of investor capital and has undergone a spectacular growth in the last decade. A brief summary of that development will perhaps clearly demonstrate its importance.

C. GROWTH IN THE OVER-THE-COUNTER MARKET

The recognized need for adequate protection in the over-the-counter market has been greatly accentuated by its expansion and increasing importance, as vividly documented by the Report of the Special Study. The average number of stocks quoted in the daily "sheets" of the National Quotation Bureau, circulated among dealers in the over-the-counter market, increased from 5,000 in 1946 to 8,200 as of January 15, 1963. Moreover, during a 10-month period in 1961 and 1962, quo-

tations were entered in over 14,000 different domestic stocks traded exclusively in the over-the-counter market. In addition, over-the-counter sales of corporate stocks, excluding sales of mutual fund shares and syndicated distributions, increased almost 700 percent in 12 years—from an estimated $4.9 billion in 1945 to $38.9 billion in 1961. The importance of the over-the-counter market is further reflected in the fact that, considering only public sales, the volume of over-the-counter stock transactions in 1961 amounted to approximately 75 percent of exchange transactions in terms of shares and 35 percent in terms of dollars.

Companies with stocks traded exclusively in the over-the-counter market constitute an important sector of our economy. A Special Study sample of over 1,600 of these companies showed that 31 percent had assets of over $10 million, 47 percent had assets of over $5 million, and 77 percent had assets of $1 million or more. Approximately one-half had 500 or more record shareholders and 16 percent had 2,000 or more.

Thus it is clear this is not a modest market, nor are these modest companies with which we are dealing. A substantial public interest needs to be served.

D. THE NEED FOR DISCLOSURE IN THE OVER-THE-COUNTER MARKET

The lack of basic investor protection in the over-the-counter market has made informed investment judgment difficult, has created grave difficulties for the professionals in the securities market who try to fulfill their responsibilities to provide sound investment advice to the public, and has introduced an artificial factor in the allocation of securities between the exchange and over-the-counter markets. It has further deprived investors of important bulwarks against fraud.

Eloquent testimony of investor needs is provided by investors themselves. The largest number of public complaints received by the Commission concern requests for information about over-the-counter companies with respect to which the public has little or no adequate information. The public should not be asked to buy and sell in darkness, nor can professionals in the securities markets advise them properly in the absence of reliable information. An analyst attempting to assess the investment worth of a company which does not file reports may be unable to find adequate or reliable data in the financial manuals. He often is relegated to the choice of utilizing that information which management chooses to make public or expending considerable effort and expense in making his own investigation. On the other hand, where reports are filed with the Commission or distributed to shareholders under its rules, this reservoir of information permits a knowledgeable evaluation on a consistent basis of data furnished by companies or other sources.

The entire Report of the Special Study is a documented analysis of the necessity for disclosure. The report demonstrates that irresponsible selling tactics, reckless investment advice, extravagant financial public relations, and erratic markets for new issues of securities flourish best where lack of information is most marked. One deplorable manifestation of these ill effects is reflected in the fact that the overwhelming preponderance of securities fraud cases in past years have involved over-the-counter securities. Vigorous enforcement efforts by the Comission cannot be a full substitute for preventive measures which would be far less costly to the taxpayer and to the victimized investor.

The availability of reliable sources of information has been a vital protection against fraud in listed securities. It enables members of the public to protect themselves against high-pressure sales campaigns by checking the representations made. Moreover, the requirement of periodic disclosure makes concealment by corporate manipulators more difficult and risky. At the same time, information disclosed in filed reports has been of considerable assistance in the detection, investigation, and prosecution of violations of the Federal securities laws, as when it provides the first suggetion of a possible illegality.

Indeed, the reporting and proxy provisions of the Exchange Act often extend protection to areas which the antifraud provisions of the Federal securities laws do not reach. For example, in one case the managers of a listed company were convicted for failure to disclose in a proxy statement a diversion of corporate funds; the entire amount taken was returned to the company. Because the fraud did not relate to securities transactions,

the Commission would have had no jurisdiction to prosecute the abuse if the company had not been subject to the Exchange Act's disclosure requirements.

Because of the crucial disparity between the exchanges and the over-the-counter market, that market undoubtedly fails to receive the measure of confidence which it might otherwise enjoy. Thus, the public may draw a fairly sharp line in its investments, as it appears to have done after the market break of a year and a half ago. It is well known that the over-the-counter market has not shown the same resiliency since that sharp decline as the exchange markets, either in terms of price or of volume.

Experience under the Federal securities laws has proven that providing basic investor protection encourages a healthy development of the securities markets. If the present double standard is eliminated, investor confidence in the over-the-counter market will be increased, the ability of companies to raise necessary capital will be enhanced, and securities will gravitate to the market best suited to them.

Moreover, the extension of the disclosure requirements of the Exchange Act to a significant portion of the over-the-counter market undoubtedly will have an effect on the entire market. The initial application of the disclosure philosophy to trading markets on national securities exchanges has created an appreciation of, and an expectation for, regular and continuous information. For this reason, many over-the-counter companies, both large and small, have been persuaded that confidence can best be maintained by voluntarily making adequate disclosures to shareholders. Enactment of H.R. 6789 should greatly accelerate this trend.

The need of the over-the-counter market for the benefits offered by this legislation is clear—a need recognized by the securities industry and important elements of the business community. In its report on S. 1168, 85th Congress, a bill similar in purpose to H.R. 6789, the Senate Committee on Banking and Currency recognized the inadequacies of the present protection afforded investors in the over-the-counter market:

"The principle of equal treatment by the law of listed and unlisted large corporations in requiring them to furnish financial information to investors has received thorough consideration for nearly a quarter of a century. Many of the arguments against S. 1168 are the same as those advanced against the original Securities Exchange Act of 1934. It is significant that many of the groups opposing the original laws have now become its stanch supporters because of its protection to investors and its furthering of the public interest. The committee believes that the same recognition of the public interest will follow the enactment of S.1168."

The need has not diminished, nor is it theoretical. The over-the-counter market has grown tremendously in securities traded and in number of investors. Only the protections have stood still.

E. EXAMINATION OF REPORTING BY OVER-THE-COUNTER COMPANIES

The disclosure habits of over-the-counter companies confirm the justifications in logic and policy for a statutory base of responsibility. On three previous occasions, in 1946, 1950, and 1956, Commission surveys have shown that the financial reporting and proxy solicitation practices of these companies were seriously deficient. Another comprehensive examination made by the Special Study corroborated these findings.

The study analyzed the reporting practices of 556 companies (other than banks and insurance companies, treated separately) which were selected on a random basis. Deficiencies ranged from a failure to distribute any reports to shareholders on the part of a significant number of companies (25 percent) to important defects in the disclosures of numerous others. The results of the Special Study's examination of proxy solicitation practices of these same companies were even more striking. Many did not even solocit proxies (24 percent). Of those that did, a clear majority omitted such vital information as the names or experience of nominees for directors (84 percent) or the remuneration of the management (95 percent).

The findings of the Special Study do indicate that disclosure patterns tend to improve with increased shareholder ownership. This improvement would, of course, be reflected in those companies with $1 million of assets and 500 shareholders that will be covered by H.R. 6789. Nevertheless, in companies of that category included in the Special Study survey, significant inadequacies were

found in reporting customs. Thirteen percent did not distribute any financial information to shareholders in 1961. Of those that did, in 12 percent of the cases, it was not certified by an independent public accountant. The proxy solicitation practices of these companies showed even greater need of improvement. Seventeen percent did not furnish any material to stockholders during 1961; 62 percent of the companies which solicited proxies involving election of directors did not disclose the names of nominees; and 92 percent made no disclosure of the remuneration of management. Significant deficiencies were found in many other respects.

The study's review of financial reporting habits would indicate—to the extent permitted by such an examination—that some companies presently furnish adequate information. A company making such voluntary disclosures should have no objection to continue doing so under a congressionally endorsed policy. Most importantly, investors in over-the-counter securities are entitled to be assured that corporate reporting meets all the tests of timeliness, sound accounting, reliability, responsibility and consistency. This can be achieved only by the imposition of legal obligations which would shape the development of appropriate accounting and other disclosures practices. Moreover, in the absence of statutory requirements, it cannot be expected that in times of corporate stress—when the need for full and accurate information is most acute—managements will necessarily disclose, on a voluntary basis, matters which may tend to reflect adversely on their activities or on their companies.

F. OVER-THE-COUNTER COMPANIES COVERED BY H.R. 6789

The necessity for disclosure has long been recognized. The extent of coverage of any disclosure requirements, however, has been a more difficult issue from the point of view of both the size and type of company to be covered. The Special Study made a particular effort to develop appropriate tests and also especially examined the disclosure practices of banks and insurance companies, examples of regulated industries which have raised special questions in the past and also during the Senate hearings on the bill.

H.R. 6789 would extend section 12, 13, 14, and 16 of the Exchange Act initially to those companies having $1 million in total gross assets and 750 stockholders of record. After a 2-year period, or at such later date as the Commission may determine, the shareholder test would be reduced to 500. It is estimated that under the 750 shareholder standard, approximately 3,100 companies would be covered of which about 400 would be banks, subject to the appropriate Federal banking regulatory agency. About 1,500 of the remaining 2,700 are already required to file reports with the Commission under section 15(d) of the Exchange Act. Under the 500 shareholder standard, the estimated coverage is 3,900 companies including 1,700 companies already reporting and 600 banks.

The selection of the recommended standard of coverage, necessarily a matter of judgment, is based on several factors. Most influential among these is investor interest as evidenced by the number of shareholders. In principle these provisions might apply to all companies in which "public" investors have an equity interest. Such inclusive coverage, however, could create a burden on companies and the Commission unwarranted by the importance of these companies in the marketplace. Accordingly, the criteria for inclusion of companies have been chosen with a view that the flow of reports and proxy statements would be manageable from the administrative standpoint and not disproportionately burdensome on companies in relation to the needs to be served.

Companies with 500 and over shareholders and $1 million in assets are affected by a substantial investor interest. In the report's analysis of companies meeting the statutory tests (other than banks and insurance companies), 40 percent had over $10 million in assets; at the lower end of the scale, only 15 percent had between $1 million and $2 million in assets. Thus, it would appear that the great majority of the companies subject to the bill will be very substantial in size and that the companies satisfying the minimum requirements are not small enterprises in any real sense of the word. The public interest is further underlined by findings of the report as to the significant trading activity in the securities of a majority of the covered companies.

Any burdens of compliance with H.R. 6789 are minimal when compared to the benefits of adequate disclosure provided by the bill. In this connection, weight should be given to the statement of Mr. Edwin D. Etherington, president of the

American Stock Exchange, on S. 1642 before the Securities Subcommittee of the Senate Committee on Banking and Currency, as follows:

"(w)e conclude that the total cost of annual compliance with all of the requirements now applicable to listed companies apparently would be in the area of $1,500 to $3,000 for the smaller industrial companies covered by this bill except in most unusual circumstances."

Furthermore, Mr. James E. Day, president of the Midwest Stock Exchange, estimated that the costs to smaller and medium size over-the-counter companies to meet the requirements of S. 1642 should not be more than $1,500 to $2,000 except in the most unusual cases: "and for many of the firms who were now using legal counsel for tax purposes and receiving regular CPA audits, as low as $500 more than they were now paying."

It is primarily because of the anticipated administrative load, particularly in the years immediately following the effectiveness of H.R. 6789, that section 3(c) embodies a phasing down in coverage. At the same time this will permit a reasonable period for preparation by the affected companies. Moreover, if for any reason the Commission could not accommodate the increased number of companies filing under the lower standard as scheduled, it could defer operation of that standard. Since the pertinent provisions of H.R. 6789 would not become effective until July 1, 1964, companies will generally not register until sometime in 1965. Costs of the program to the Commission for fiscal year 1965 are estimated at approximately $600,000.

G. DISCLOSURE WITH RESPECT TO BANK SECURITIES TRADED IN THE OVER-THE-COUNTER MARKET

H.R. 6789 would apply to over-the-counter banks meeting the statutory standards. However, the bill also provides that all the powers, functions, and duties of the Commission with respect to bank securities shall be delegated to the appropriate Federal banking regulatory authority upon its request. S. 1642 as passed by the Senate contains one difference in treatment of bank stocks from H.R. 6789. Under the Senate bill, the administration and enforcement of the disclosure, proxy, and insider trading provisions of the Exchange Act with regard to the bank stocks would be directly vested in the Federal bank regulatory agency with primary examining and supervisory authority—the Comptroller of the Currency for national banks; the Federal Reserve Board for member State banks; and the Federal Deposit Insurance Corporation for nonmember, insured State banks.

As the Senate committee report indicates, the reasons for the Senate amendment were essentially to assure integration of the disclosure requirements with the Federal bank regulatory structure and to avoid a situation where some, but not all, banking agencies would request administration of the applicable 1934 act provisions. The Commission supports this amendment, which is but a short step from S. 1642 as introduced and H.R. 6789. Our goal is the establishment of the principle of disclosure, proxy, and insider trading requirements for bank stocks.

The Report of the Special Study demonstrates the substantial importance of over-the-counter bank stocks both in terms of number of shareholders and amount of dollars invested. Approximately one-fifth of the securities designated in the 3-month period covered by the January 1962 summary of the National Quotation Bureau, Inc., were bank stocks. Further data from the special study indicates that approximately 600 banks would be covered by H.R. 6789. Moody's Bank and Finance Manual for 1963 lists over 550 banks meeting the coverage standards. The aggregate number of shareholders of these banks (without adjustment to eliminate duplication) was approximately 1,600,000 and the aggregate market value of the bank stocks held by these investors, as of December 31, 1962, was about $22.5 billion.

These figures illustrate the extremely broad investor interest in over-the-counter bank stocks and the corresponding need for the disclosure requirements now recommended generally for over-the-counter companies. Do investors in bank stocks need this protection any less than other investors? At the hearings on S. 1642, there was general support—by Chairman Martin of the Federal Reserve Board, by the American Bankers Association, and by others—of the principle of adequate disclosure for bank stocks. The only significant question raised at the hearings related to administration of these provisions: whether by the Commission; or by the banking agencies, if they requested the responsibility as proposed in H.R. 6789; or directly by the banking agencies as contained in S. 1642.

As noted, the Federal banking regulatory authorities involved in this bill are the Comptroller of the Currency (as to national banks), the Federal Reserve Board (as to members which are not national banks), and the Federal Deposit Insurance Corporation (as to nonmember banks). We understand that either the Comptroller or the Federal Reserve Board would have jurisdiction over most of the banks covered by this bill. Under the amended Senate bill, jurisdiction to administer these provisions would vest directly in bank agencies. There would be no residual control in the Securities and Exchange Commission. These agencies could adopt whatever rules and forms they deemed appropriate. As we have noted, the Commission supports the amended bill. In sum, we have no desire to take direct responsibility over bank disclosure in any respect. It is only the principle of adequate disclosure which we assert.

Accordingly, the only remaining issue is whether present practices of banks are such that the purposes of H.R. 6789 have already been satisfied. The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. These objectives neither utilize the same tools nor achieve the same ends as investor protection. The purpose of disclosure is to place the investor in a position to make an informed judgment on the merits of a security, and to provide a basis for comparing that security with others issued by companies in the same or different industries. Essentially this purpose is achieved through the furnishing of financial information which provides a uniform pattern of reporting based on understood and generally accepted accounting practices. To say that bank regulation renders this disclosure philosophy unnecessary is to say that bank regulation is an effective substitute for the free exercise of an investor's judgment. Controls which protect against embezzlement and which assure adequate reserves serve important objectives, but not the objective of informed investment. To hold otherwise would be to imply that, because of such regulation, any bank security is, without more, a worthy investment at any price.

The emphasis in the objective of banking regulations is manifested in its financial reporting requirements. A key report in investment analysis, the income statement, is filed on a confidential basis with the banking authorities and, except at the option of a particular bank, is not available to the public. No attention is given to the protection of investors in proxy solicitations with the exception of recent efforts of the Comptroller of the Currency. Nor are there any restrictions with respect to insider trading.

The inadequacies of this reporting structure for the investor's purposes have been brought out by the Report of the Special Study. Its analysis revealed that the disclosure practices of banks fall far short of the standards imposed under sections 13, 14, and 16 of the Exchange Act. In the category of banks that would be covered by H.R. 6789, the report's findings show that 10 percent did not send any financial information to their shareholders. Of those that did, 32 percent failed to include the most important document, a profit-and-loss statement. These conclusions are illustrative of the fact that uniformity of reporting to provide some basis for comparing bank stocks among themselves or with other stocks has been notably lacking. Significant deficiencies, moreover, were also found in the proxy practices of banks. For example, in 88 percent of the solicitations that involved election of directors, the names of the nominees were not stated and in 95 percent their experience was not given. In all cases management remuneration was not furnished.

There have been recent efforts on the part of the Comptroller of the Currency to provide by annual reporting and proxy rules some protections for bank investors. These steps represent a pioneering effort by the Comptroller and a welcome recognition of the need for action. The regulations do fall below those contemplated by the Exchange Act. For example, they do not provide for review of proxy materials prior to their distribution, contain no general prohibition of the use of false or misleading information, and specifically deny the right of shareholders to secure relief against false or misleading solicitations. Thus, useful administrative practices, along the lines developed by the Commission, for assisting companies to transmit properly prepared proxy materials, are not available—nor are effective private sanctions. As another example, there is no requirement that information be disclosed about the interests of officers or directors in material transactions or matters to be acted upon by shareholders. Of course, the Comptroller's regulations do not provide any protection against insider trading. Furthermore, they are only applicable to some national banks and leave a large number of banks—national, member, insured, and State—

in which there is substantial investor interest free from the responsibility to make necessary disclosures.

The regulations of the Comptroller have been adopted pursuant to his general authority to require special reports. There is, of course, no established congressional expression of policy as to the content of reports to or for stockholders and consequently no assurance of their endurance. Furthermore, to the extent that these regulations already provide protections equivalent to those afforded by the Exchange Act, there would appear to be little cause for objection to their express congressional approval in a statute providing for their administration by appropriate banking authorities.

For these reasons the Commission strongly recommends that investors in bank stocks be given the basic protections afforded by H.R. 6789—protections to be administered by the proper banking authorities.

H. DISCLOSURE WITH RESPECT TO INSURANCE SECURITIES TRADED ON THE OVER-THE-COUNTER MARKET

The Special Study gave special attention to stock insurance companies because of the claim that existing State regulation makes superfluous the application of the disclosure protections provided by H.R. 6789. The Report of the Special Study found these stock companies were an important part of the over-the-counter market in accounting for approximately 5 percent of the domestic issues traded. We estimate that about 400 insurance companies meet the standards of H.R. 6789, of which approximately a third are already subject to our reporting rules. The information available on these 400 companies indicates that they have over 1,300,000 shareholders and the market value of their outstanding shares is over $20 billion. It is strikingly evident that insurance companies represent substantial centers of investor interest. Accordingly, unless persuasive reasons exist to the contrary, there would appear to be no justification for depriving investors in insurance companies of those benefits afforded investors in other over-the-counter securities. The Commission believes that no such justification exists.

It should be pointed out that mutual companies, which were not examined by the Special Study, are not subject to the bill. They do not have stockholders as such; and, even more important, there are no shares being traded.

From the beginning, Congress has been of the view that investors in insurance companies need all of the protections afforded by the Federal securities laws to investors in other businesses. When an insurance company goes to the public for funds, it must comply with the Securities Act of 1933; similarly, such a company is covered by the Exchange Act. Thus, approximately 150 insurance companies, including about 100 life insurance companies, are now subject to the reporting requirements of that act as a result of having made a registered offering of securities. The market value of the shares of 126 of these insurance companies (as to which information is presently available) is over $5 billion; their number of stockholders is estimated at approximately 700,000.

Existing regulation of insurance companies, which rests almost exclusively in the hands of the States, is designed primarily for the safeguarding of policyholders and is an inadequate substitute for the investor protections provided by H.R. 6789. Again it should be emphasized that the bill is intended to foster publication of reliable financial and business data so as to allow investors to exercise a rational judgment and thereby to promote an informed distribution of capital among companies and industries. The thrust of insurance regulation is to protect policyholders' claims against a company. Accordingly, the stress is laid upon the adequacy of reserves and upon investment in conformity with specified standards. Consistent with those aims, information in the required reports is directed to the solvency of a company and not to its usefulness for making investment decisions.

In other words, a company may be sound enough to meet its obligations, but its stock may or may not be an attractive investment or speculation at current prices. No one, not even a sophisticated financial analyst, can arrive at a judgment as to a stock's merits unless there is adequate information available. Disclosure, therefore, is necessary to protect at least 1,300,000 owners already having more than $20 billion invested in the insurance companies covered by the bill—as well as the potential investors in this active area of the markets.

H.R. 6789 would provide nonfinancial information not now generally available under State insurance regulation. For example, a State report typically contains only limited data concerning material transactions of insiders in com-

parison with the requirements of the Commission's rules. Moreover, there is no provision under State regulation for timely disclosure of events of major importance to investors, such as major acquisitions of assets, significant litigation, or the issuance of substantial amounts of stock. In contrast, the Commission's form 8–K, the filing of which would be required by H.R. 6789, must be filed soon after the occurrence of any of these material events. Furthermore, State regulation has nothing comparable to the Commission's proxy rules—which place financial and business information in the hands of the shareholders, nor does it provide any substitute for the various safeguards against insider trading.

The Special Study's examination of the reporting practices of insurance companies confirms that State regulation has not in the past produced the flow of necessary basic information that will result from H.R. 6789. In the category of companies in the study survey that would be covered by H.R. 6789, 12 percent failed to furnish any financial information to shareholders and 50 percent did not supply an income statement. Proxy soliciting practices were even more inadequate. Eight percent of the companies responding did not transmit any proxy material to shareholders. When shareholders were furnished these materials, the information provided was almost always greatly inadequate by standards applicable to listed companies. The serious weaknesses in this area were noted in a 1960 report by a subcommittee within the National Federation of Financial Analysts Societies:

"It is our conclusion that annual reports (to stockholders) of the life insurance industry are the poorest of any major industry in the United States."

There may well have been improvements since that date; the findings of the report seem to indicate they are modest ones.

Insurance companies should be the first to appreciate a primary aim of H.R. 6789—to provide investors with adequate information. They continuously invest other people's money and rely on the adequacy and reliability of the disclosures about the companies in which they invest. Those who invest in insurance companies should be entitled to no less reliable information.

The importance of publishing and disseminating financial information about a company, of course, rests firmly on the desirability of informed investor judgment. However, the absence of this information is also conducive to fraudulent practices and overreaching—which have occurred in recent years with an undesirable frequency in insurance company promotions. The assets and liabilities of insurance companies are usually of an intangible nature and, despite the vigilance of the State insurance commissioners, opportunities do exist for manipulation of these assets and liabilities by insiders in a manner detrimental to the interests of investors.

The insurance business has grown rapidly in the last decade. During the 10-year period from 1951–61, the number of life insurance companies in the United States has more than doubled, from 659 to 1,457, with a high concentration of this growth in the South and Southwest. Many of the new insurance companies which emerged during this period were inevitably promotional to some degree and their operations presented problems of investor protection. In its 23d annual report (1957), the Commission, describing its most pressing enforcement problems, included this statement:

"Recent economic conditions have been relatively favorable for the sale of promotional stocks of new ventures, particularly in fields in which the securities of established enterprises have shown marked gains. For example, many new insurance and financial ventures have been promoted, particularly in the south-central, southwestern, and southeastern parts of the country, and their securities have been distributed either through registration or regulation A, or more commonly in reliance upon the intrastate exemption. Many of these issues and the sales techniques employed in their distribution appear to involve abuses and possible violations of the antifraud and other provisions of the Securities Act or the Securities Exchange Act, which require extensive investigation. The large number of these promotions and the rapidity with which they have increased has placed a most serious burden on the Commission's field enforcement personnel charged with the conduct of such investigations."

Similar statements were made in the 22d and 24th annual reports of the Commission and these problems have not disappeared.

Special questions have been raised with regard to the financial reporting problems of life insurance companies. I should therefore like to describe the Commission's procedures and requirements respecting these companies—an area in

which the Commission has already had broad experience, as evidenced by the approximately 100 life insurance companies now filing annual and periodic reports.

At the outset a few basic points should be noted. First, the enactment of H.R. 6789 will not introduce new accounting regulations or alter the accounting practices of life insurance companies. There will be no need for a separate set of books or the establishment of new procedures. Second, life insurance companies can satisfy the financial reporting requirements of the Exchange Act essentially by filing the reports prepared annually for State authorities. Indeed, these reports must conform to the requirements of the State insurance commissions. Third, the reports filed with the Commission need not be certified by independent public accountants. These points reflect present Commission policies. The Commission has made very clear in a letter to Senator Robertson during the hearings on S. 1642 that it expects to continue to follow these policies in the future and the Senate committee report stated it expects the Commission to do so.

I should briefly like to expand on these points, which are embodied in proposed article 7A to our regulation S–X. This proposed article specifically governs the financial statements of life insurance companies and basically embodies Commission practices. Comments have been received on the proposal and, as revised, it will be presented to the Commission for adoption after further conferences with interested parties.

I should first reemphasize that the financial reports filed by life insurance companies under the Exchange Act are not required to be recorded, certified, or audited by independent public accountants. Company officials may, in effect, file with us the financial statements which they file with the State insurance commissioners, together with certain additional explanatory notes. There is apparently an erroneous impression in the life insurance industry that an independent audit would be required under the bill. The facts are that the financial work of the company's own employees exclusively will be accepted under H.R. 6789. This has been the practice of the Commission for 30 years and, as I have stated, we are committed to continue it.

Moreover, article 7A does not prescribe any method of reporting which is inconsistent with the methods of reporting required in the annual statement blank adopted by the National Association of Insurance Commissioners. Indeed, the proposed article does not require the reporting of any financial information to the Commission which cannot be obtained from data contained in some form in the uniform NAIC annual statement or which is not otherwise readily available. The only difference between the reporting that will be required by the proposed Commission article and that currently required by the States is that the former will include substantially less detailed information pertaining to insurance matters than that included in the NAIC statement. The only other change is that the proposed article would require certain brief explanatory notes, including a historical analysis of surplus, for the benefit of investors not conversant with insurance accounting practices and terminology. I have gone into these points in more detail in letters to Chairman Harris and to certain of the State insurance commissioners, and I would like to offer those letters for the record.

We stress that, as in the case of over-the-counter companies generally, insurance companies will not encounter difficulties or incur significant expenses in satisfying the provisions of H.R. 6789. Indeed, an important expense for most companies will be an audit by an independent certified public accounting firm—which is not required for insurance company reports under Commission practice. Moreover, as we have pointed out, insurance companies must already file detailed financial reports in each State exercising jurisdiction over them and presumably have adequate staffs to cope with the reporting requirements of State regulation. Their compliance with H.R. 6789 should prove to be a matter of relatively small additional cost and burden. To further coordinate our efforts with the insurance commissioners, we have suggested to them that it would be possible, if the National Association of Insurance Commissioners so desired, to modify the convention blank by adding an additional page of notes after the principal financial statements containing the explanatory material which we need. Should this be done, a life insurance company could simply file with us a copy of its filing with the State insurance commissioners as full compliance with the financial portion of its report.

It should also be kept in mind that the great majority of life insurance companies subject to the bill will be very substantial in size and that the companies meeting the minimum requirements are not small enterprises in any real

sense of the word. In the study's analysis of insurance companies meeting the statutory tests, over 50 percent had over $10 million in assets; at the lower end of the scale, only 18 percent had between $1 and $2 million in assets. Finally, in this connection, I note that, of the estimated 400 insurance companies that would be covered by the bill, 126 are already required to file periodic reports with the Commission under section 15(d) of the Exchange Act. For these companies, the chief additional expense will be in complying with the proxy requirements of the bill.

In summary, the importance of insurance companies to the public as a medium of investment is undeniable. Yet the information available about many of these companies is totally inadequate. It seems clear that only H.R. 6789 will provide that minimum amount of data necessary for informed investing. Because of the applicability of the reporting requirements to almost 150 insurance companies, investors in some of these companies are already receiving partial protection. Complete protection for investors in all insurance companies meeting the statutory standards is necessary and desirable.

In opposing the provisions of the bill, representatives of insurance companies have pointed to the possibility of action in the areas covered by the bill by the National Association of Insurance Commissioners, which then presumably would be implemented by the 50 States. Undoubtedly any developments with respect to proxy or insider trading regulation would require action by the 50 State legislatures. Thus, there would be no guarantee of immediate response, or assurance of uniform standards. The findings of the study demonstrate that action is needed now. Because of the widespread investor interest in insurance companies—not limited to State lines—that action should be on the Federal level and in the context of a statute which applies to all companies, whatever their business, and establishes nationwide, uniform minimum standards. The necessity for such standards in the securities markets, of course, was a basic reason for enactment of the Federal securities laws. Moreover, it is clear that H.R. 6789 would not infringe upon action by the States; for example, the various States could impose more restrictive rules on insider trading than those contained in the bill. All of the Federal securities acts specifically allow action by the States in the areas covered, limited only by a requirement that such State action not be inconsistent with the Federal statutes and rules. H.R. 6789 follows this same pattern.

In the opinion of the Commission it is most important that insurance companies be included under H.R. 6789. The Senate has approved this judgment in its passage of S. 1642 and the Commission strongly urges the House of Representatives to do the same.

I. THE INSIDER TRADING PROVISIONS

We have thus far focused on the extreme importance of extending basic disclosure principles to the over-the-counter market. Prior proposals to equalize protections between markets have included as a necessary ingredient safeguards against insider trading abuses provided by section 16 of the Exchange Act. This necessity still prevails; accordingly, H.R. 6789 would make section 16 apply to those over-the-counter companies to be covered by the reporting and proxy requirements.

The Commission's experience in administering the securities laws has demonstrated the need for this portection in the over-the-counter market. The analysis of the Report of the Special Study supports this experience. The absence of adequate disclosure by over-the-counter companies, the difficulties of preventing insider trading misconduct through traditional enforcement procedures, the lack of data concerning the volume and prices of transactions, and the important extent to which insiders control over-the-counter companies—these factors create conditions conducive to insider speculation and manipulation on the basis of information not available to the public. Expanded interest in over-the-counter securities, together with greater volatility in the market for many of these securities in the postwar period, has added to the potential for abuse. The extension of section 16 should have as sound an effect as it has had in the exchange markets.

These provisions, of course, do not prevent an insider from investing in his company's stock. He may buy or sell as much as and whenever he pleases. However, because of his fiduciary relationship to the issuer, he must report his securities transactions, disgorge any short-swing profits, and not sell his company's stock short.

Section 8(b) of the bill exempts from the profit recovery provisions of section 16(b) and the short-selling prohibitions of section 16(c) transactions by a dealer which are part of his ordinary trading activities in a company's securities and incident to his establishment or maintenance of a primary or secondary over-the-counter market for those securities. This provision is designed to take care of the so-called sponsorship problem.

As a result of a prior connection with a company, most usually as underwriter, it is claimed that a dealer necessarily undertakes to make a market in its securities—in other words, act as a "sponsor." In addition, because of his broad financial experience, he is sometimes sought as a member of the board of directors. If section 16(b) were applied to market-making transactions by broker-dealer directors, they would be compelled to cease their market-making activities or resign their directorships. This "director-market-maker" issue has been a subject of concern in prior legislative proposals. The Report of the Special Study found that this combination involved a little less than 10 percent of all registered broker-dealers and an estimated 13 percent of those over-the-counter securities which evoked some trading interest during a 10-month period examined by the study.

The Report of the Special Study recommended the general application of section 16 in this area, with exemptive power in the Commission. H.R. 6789 takes a somewhat different approach and would permit the continuation of the joint function of market-maker and director under certain conditions. Under this section, the Commission would have rulemaking power to prescribe the terms under which securities would be deemed held in an investment account and under which transactions would be considered made in the ordinary course of business incident to the establishment or maintenance of a primary or secondary market. The Commission would also have power to define each of these terms. The proposed section would avoid the necessity of considering applications for exemption on an ad hoc basis, as recommended by the Special Study Report.

Insofar as broker-dealer insiders are concerned, the Commission has special powers to curb the misuse of inside information. Analysis of the reports which would be furnished pursuant to subsection 16(a) and the periodic inspections of dealers by the Commission's staff will serve as a deterrent. Moreover, overreaching by the actual abuse of inside information would violate the anti-fraud provisions of the securities acts and would be the basis for administrative action against a firm.

J. OTHER PROVISIONS OF THE REGISTRATION REQUIREMENTS FOR OVER-THE-COUNTER COMPANIES

Securities issued by foreign companies and certificates of deposits issued against such securities initially would be exempt from the proposed registration requirements for over-the-counter securities. The commission could terminate the exemption for a class or classes of such securities only upon a finding that they enjoy a substantial public market in the United States and that continued exemption is not in the public interest or consistent with the protection of investors. These procedures would afford interested companies, brokers, dealers, and investors adequate opportunity to bring to the Commission's attention all relevant considerations.

In principle, U.S. investors in foreign securities ought to be afforded the same protections as are provided for investors in domestic securities. As a practical matter, however, enforcement of the pertinent provisions of H.R. 6789 against foreign companies outside the jurisdiction of the United States would present serious difficulties. Many of these companies have no assets or operations in the United States, have never sought funds in the American capital markets, and have never listed a security on an exchange. Even in the case of listed securities, where companies voluntarily assume certain obligations, the Commission has found it necessary to provide an exemption from the proxy and insider trading provisions for foreign issuers other than North American and Cuban companies.

The Commission believes that H.R. 6789 affords the most effective and practical solution to the foreign security problem. It takes account of the difficulties of enforcement against foreign companies, provides the possibility of greater protection to existing trading markets in foreign securities, and permits the Commission to deal flexibly with the application of the disclosure requirements in the context of particular issuers or classes of issuers.

Under section 3(d) of the bill, the Commission would have broad powers to exempt companies, persons, and securities from the reporting, proxy, and insider trading provisions. Exercise of these powers—together with a broad authority to classify—will permit a responsible accommodation of the requirements of the public interest with the varied circumstances of over-the-counter securities and their issuers. For example, if there were any company with no business activity or very limited trading interest, it could be exempted from all but minimal reporting requirements.

K. OTHER AMENDMENTS PROPOSED BY H.R. 6789

In addition to extending the disclosure protections of the Exchange Act, various provisions of H.R. 6789 are intended to make the basic disclosure philosophy of the securities acts more effective. A most important one of these, section 11 of the bill, would amend section 4(1) of the Securities Act of 1933 to extend the present 40-day requirement for delivery of a prospectus by a dealer to 90 days for new issues—a registered offering by a company which has not previously sold its securities pursuant to an effective registration statement under the Securities Act.

As indicated by the Report of the Special Study of Securities Markets, during the years 1959 to 1961, the flotation of new issues reached the highest level in history. "Hot issues," usually stocks of companies in certain "glamour" industries, were eagerly sought in the expectation that their price would quickly rise to a substantial premium. Sometimes this expectation was fulfilled; but in many cases the market price of a "hot issue" later fell to a fraction of its original offering price.

The Report of the Special Study pointed out that substantial redistributions of "hot issues" often occurred through trading after the original offering was purportedly completed. These redistributions were frequently marked by intensive sales efforts by dealers to solicit purchases at high premiums over the initial offering prices. The Report of the Special Study concluded that:

"* * * persons who bought in the aftermarket often were less sophisticated and more susceptible to the allure of publicity and rumor about 'hot isues.' These persons, who frequently purchased at premium prices, probably needed the benefits of the information contained in the prospectus more than the original distributees. Yet in many cases they never saw a prospectus or offering circular."

The Commission believes that a period of 90 days is a more realistic appraisal of the time during which the actual distribution process continues in the case of many new issues. This requirement is, of course, substantially shorter than the 1-year period, which prior to 1954 was required by section 4(1) for delivery of prospectuses for all issues.

This proposed amendment of section 4(1) will not be a cure-all for the "hot issue" problem. It will, however, assist in the establishment of more orderly and informed trading in the aftermarket. Under this amendment, the Commission also could, where appropriate, shorten either the 40- or 90-day period in the case of companies for which a reservoir of public information exists. This will permit greater flexibility in the administration of the disclosure requirements of the Securities Act of 1933.

Other sections of H.R. 6789 amending the Exchange Act would also reinforce the fundamental disclosure principles. Under section 5(c) a company subject to the proxy rules which did not solicit proxies would be required to furnish shareholders with information equivalent to that contained in a proxy statement prior to the annual or other meeting of shareholders. At the present time avoidance of the disclosures required by the proxy rules is made possible by the simple device of not soliciting proxies. Thus, many stockholders can be deprived of material information. The New York Stock Exchange does require issuers of securities listed on that exchange to solicit proxies each year. The American Stock Exchange has embarked on a program to achieve the same result. However, similar requirements as to listed or unlisted securities are not imposed by all other exchanges or by any other authority. This problem of nondisclosure would be accentuated by the extension of the proxy rules to over-the-counter companies where nonsolicitation could occur more frequently because of management's relatively larger holdings. Thus, section 5(c) is a necessary step if shareholders in over-the-counter companies, and certain listed companies, are to be assured of informed voting rights.

In addition, section 6(d) would require the filing of reports by any company which offers its securities under a registration statement so long as it had 300 holders of the class of security offered. This section is only a modification of the present law which reflects a longstanding congressional policy that a company which goes to the public for funds should not subsequently be free to seal off its operations from disclosure.

Sections 3(a) and 4 would obligate both listed and over-the-counter companies subject to the reporting requirements to file their "material contracts" not made in the "ordinary course of business." This information is of substantial importance to investors; it is now available to them only in the case of companies registering securities under the Securities Act and only at the time of registration. Filing of the contracts will enable the Commission to determine more readily whether there has been adequate disclosure and would facilitate the efforts to integrate the requirements of the Securities Act of 1933 and of the Securities Exchange Act of 1934.

Under section 6(c) of the bill, the Commission could make and publish findings that any person has failed in any material respect to comply with the requirements of sections 12, 13, or 15(d). This establishes an administrative procedure, similar to that provided in proceedings to delist securities under section 19(a)(2) of the Exchange Act, for apprising investors of materially misleading filings and for the resolution of accounting and other complex and technical questions involving the disclosure provisions of the act. The administrative remedy of a fine for companies that have failed to file reports, now contained in section 32(b) of the Exchange Act, would be repealed by section 10 of the bill. Enforcement of this provision has proven administratively unworkable.

Sections 5(b) and 6(c) of H.R. 6789 would establish certain controls in the over-the-counter market comparable to those which the Commission presently possesses with respect to the exchange markets. The Commission may now regulate the transmission by brokers of proxies with respect to exchange securities. Section 5(b) will extend this power to the proxies of over-the-counter companies registered under H.R. 6789. Moreover, under section 6(c) the Commission would be empowered to suspend summarily over-the-counter trading in any security for 10-day periods, as it may do with an exchange security, when fraudulent or manipulative practices have deprived the security of a fair and orderly market. Trading would be permitted to resume upon adequate disclosure and dissemination of the facts material to investment decision.

Finally, section 12(f)(3) of the Exchange Act, which authorizes "unlisted trading privileges" on an exchange where a company is subject to obligations substantially equivalent to those applicable to listed companies, would be repealed by section 3(b) of H.R. 6789. Upon the registration of over-the-counter companies under this bill, approximately 3,900 additional companies would be then eligible for unlisted trading on national securities exchanges. The Commission believes that repeal of 12(f)(3) will avoid an unduly broad and unintended effect for this clause and will assure a desirable conformance by companies with the listing requirements of an exchange as a prerequisite to enjoying the privileges of trading on that or other exchanges. Other amendments to section 12(f) clarify the Commission's authority to consider all factors pertinent in the public interest in determining whether to extend or terminate unlisted trading and preserve existing unlisted trading privileges for securities.

This completes my discussion of the first major area covered by H.R. 6789; namely, improvement of investor protection through extension of fundamental disclosure requirements. I would now like to turn to the second major area of the bill.

III

The second major area with which H.R. 6789 deals is qualification standards and controls over those in the securities business. One of the basic purposes of the Securities Exchange Act of 1934 is to regulate conduct of brokerage firms and persons associated with them, both through direct SEC controls and through self-regulation, with appropriate Commission oversight.

The vast growth in the securities markets has been accompanied by a rapid increase in the number of securities firms and their employees. For example, the membership of the National Association of Securities Dealers (NASD), the self-regulatory agency for the over-the-counter market, has more than doubled since 1945; over the same period registered representatives have increased from about 25,000 to 95,000 and branch offices of members from 790 to 4,713. This

expansion—accompanied by a comparable growth in securities traded and in the number of investors—has strained the regulatory pattern of the securities acts and emphasized the dramatic need for stronger and more refined controls. Accordingly, the Commission recommends the enactment of a series of proposals, contained in section 2, 6, and 7 of the bill, designed to enlarge the scope of self-regulation; to raise the standards for entry into the securities business; to refine Commission disciplinary controls over brokers, dealers, and their employees; and to clarify and improve existing provisions dealing with related matters. The controls provided would have their primary impact upon those who deal in over-the-counter securities and would complement the protections recommended with respect to companies whose securities are traded in that market. At the hearings on S. 1642, these provisions had the strong support of major groups in the securities industry, including the NASD which would have important responsibilities under them.

A. SUMMARY OF PRESENT LAW AND PROPOSED AMENDMENTS

Before I describe the proposed amendments, a short outline of present law may be helpful. Control over over-the-counter brokers and dealers begins with the requirement that they register with the Commission. Section 15 of the Exchange Act provides for revocation or denial of registration if a firm, or any person associated with it, (1) has been convicted of a crime involving securities transactions or the securities business; (2) is enjoined from engaging in any act or practice in connection with securities transactions; or (3) has willfully violated the Securities Act or the Exchange Act.

Section 15A of the Exchange Act authorizes registration with the Commission of national securities associations. These organizations of over-the-counter brokers and dealers were intended to provide a medium for self-regulation for over-the-counter market comparable to the securities exchanges in the listed market. Section 15A contains rather detailed provisions concerning the rules, organization, and disciplinary proceedings of such associations and gives the Commission a certain amount of regulatory power over them. At present, only one association, the NASD, has registered and the great majority of over-the-counter firms are members.

Against this background of existing law, the principal proposed changes are as follows:

1. All over-the-counter broker or dealer firms would be required to be members of a registered securities association.

2. Registered securities associations would be required to adopt rules establishing standards of training, experience, and competence for members and their employees and to establish capital requirements for members. The Commission's powers to change the rules of an association would be expanded to include these rules.

3. In a disciplinary action, the Commission could proceed directly against an employee of a broker or dealer in lieu of proceeding against the entire firm, and the authority of a national securities association to do the same would be clarified. The Commission could also impose sanctions short of revoking registration, such as a temporary suspension or censure.

4. Certain other changes are proposed, including a slight broadening of the category of crimes, injunctions, acts, and omissions that afford a basis for disciplinary proceedings by the Commission. In the case of brokers and dealers registered with the Commission, the necessity for proving that the mails or instrumentalities of interstate or foreign commerce were used in a particular proscribed transaction would be eliminated. Also the exemption from registration for brokers or dealers whose business is "exclusively intrastate," but who use the mails or any instrumentality of interstate or foreign commerce would be repealed. Finally, certain other limited changes in existing law would be made.

B. REQUIREMENT OF MEMBERSHIP IN SELF-REGULATORY AGENCY

Self-regulation by industry organizations under the supervision of the Commission provides a significant dimension to regulation of the securities markets. This concept of self-regulation is evident in section 6 of the Exchange Act which imposes a duty upon exchanges to establish and enforce rules of fair dealing for their members. It was notably reaffirmed in 1938 when Congress enacted section 15A and authorized a similar regulatory pattern for the over-the-counter market. The Commission has agreed with the report of the study 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 important reliance on self-regulation rests on two principal premises: First, self-regulation provides an alternative to more pervasive direct control by government, which would be expensive to the taxpayers and burdensome to the industry. Second, it can be a more sensitive means for developing high standards of business conduct. While self-regulation has significantly contributed to investor protection, the Report of the Special Study recommended, and the Commission strongly agrees, that the responsibilities of the self-regulatory agencies should be substantially expanded and made more effective in various areas. These recommendations envisage a more important role for self-regulation in establishing standards for investor protection. To be truly effective, these standards must be observed uniformly throughout the industry or there will be a void which could be filled only by Commission action. This is sharply illustrated by the Commission's recommendation in H.R. 6789 for standards of qualification for those in the securities business, to be established and administered by the self-regulatory agencies. In a qualification system which contemplates the complementary efforts of government and industry, all groups subject to government controls should also be subject to industry controls, either through the NASD or through similar organizations. In the light of these considerations, it would not be in the public interest to permit any broker or dealer, at his option, to exempt himself from the structure of self-regulation and its corresponding control simply by choosing not to join a self-regulatory agency. Accordingly, section 6(a) of the bill would require all brokers and dealers to join such an agency, subject to a power in the Commission to grant exemptions where necessary and appropriate.

At the present time membership in the NASD is primarily based on the economic inducements authorized by section 15A(i) of the Exchange Act that no member shall deal with a nonmember broker or dealer except at the same prices and upon the same terms as such member deals with the public. A practical effect of this provision, and the corresponding NASD bylaws, is that nonmembers cannot obtain underwriting discounts in distributions by members or other possible benefits in trading with them. Consequently, most over-the-counter brokers and dealers find it economically necessary to be members of the NASD. A limited number, however, restrict their operations to retailing directly to the public securities of companies with which they have some association; for example, as the sole underwriter. It is important that this group, which includes retailers of mutual fund shares and real estate securities, be brought within the self-regulatory scheme.

A Special Study analysis, as of February 28, 1962, indicated that 1,035 of the 5,785 registered brokers and dealers were not members of the NASD. Of these, approximately 40 percent were either new firms who had not yet commenced business or existing firms which had gone out of business but had not withdrawn their registrations. About 9 percent were exchange members who presumably do a very limited over-the-counter business. Approximately 20 percent were engaged primarily in real estate, oil royalties, savings and loan shares, insurance, and the like. Many in the above two categories would probably qualify for exemption under the Commission's rulemaking power. The remaining firms, about 300, would be the principal subjects of this amendment. It should be made clear that certain of these are very substantial organizations. For example, two mutual fund distributors have selling forces of 7,500 and 3,200.

No industry organization, nor trade association, has objected to the requirement of compulsory membership. Indeed, it is significant that the Association of Mutual Plan Sponsors, which includes among its membership an important segment of those dealers who are not members of the NASD, supported the notion that the principle of self-regulation should be extended to all members of their industry.

Registered securities associations are not private clubs. They are organized under statutory authority to perform under governmental oversight regulatory functions in the over-the-counter market. The requirement of membership in a registered securities association should raise no questions of lack of due process or excessively broad delegation of powers in view of the extent of governmental oversight. For example, the Commission can direct that a broker-dealer be admitted to membership. Any new rule proposed to be adopted by an association must be approved by the Commission and any existing rule can be

abrogated by it. All disciplinary actions are subject to review by the Commission and to further review by an appropriate U.S. court of appeals.

Finally, it should be pointed out that the Exchange Act contemplates that national securities associations, other than the NASD, can appropriately be formed. It is necessary that the Commission find that the size, scope of transactions, geographical distribution of the membership, and organization of the association are of such a character as to enable it to comply with the provisions of the act and to carry out the purposes of the section. In addition, Congress has explicitly declared that registration as a national securities association is to be limited to organizations which are "a proper subject of national concern." If a group of responsible dealers who meet these standards should wish to form and register a national securities association, the Commission would in no way obstruct its registration. On the contrary, we would be glad to assist in achieving compliance with the requirements of the act.

C. STANDARDS OF QUALIFICATION

The Exchange Act presently embodies the concept that anyone, regardless of fitness, competence, or capability, may enter into the securities business and assume any role in that business, unless he has been found guilty of recent securities violations. The Report of the Special Study confirms the Commission's belief that this concept is obsolete and no longer in the public enterest. The steady growth in the number of investors, the complex nature of the securities markets, the reliance which the investing public necessarily places upon the competence and character of professionals in those markets: all of these factors militate against permitting the incompetent and unqualified to enter the industry. These conditions subject the public to undue hazards and unnecessarily complicate the task of regulation.

The hazards are illustrated in an analysis by the Special Study of violations committed by securities firms. Almost 28 percent of new firms registering with the Commission during the first 3 months of 1961 had no experienced persons among their principals (proprietors, partners, officers, and large stockholders), and over 50 percent of the firms were in the hands of persons with under 2 years of experience. Further examination disclosed that the newest member firms of the NASD, which are generally controlled by persons having less experience than principals of older firms, were responsible for a heavy preponderance of the offenses drawing the most severe penalties in disciplinary actions. These offenses often appeared to be attributable to their principals' lack of familiarity with the technical and financial aspects of the business.

Certain of the major exchanges, particularly the New York Stock Exchange, have taken the initiative in this area and established standards of competence, experience, character, and capital. These, however, have only a restricted impact, because of the selective nature of exchange membership. The void in the over-the-counter market has only been partially filled by the NASD. The Commission believes that the self-regulatory agencies, under its supervision, are particularly equipped to develop and administer qualification standards for those in the securities business. Accordingly, it is recommended in section 7(a)(3) of the bill that responsibility be given to the NASD for the establishment of such standards, including those relating to training and experience for its members and their employees, and capital requirements for members. In this manner all persons dealing in over-the-counter securities would have to meet certain basic requirements, which could vary with the responsibilities of the job—thus, branch office managers would have to meet higher tests of experience than salesmen. In establishing criteria, the NASD could adopt appropriate "grandfather" clauses exempting existing members or their employees, either permanently or for a transition period, from some or all of the qualifications required of new entrants. The Commission would have to approve these standards and could change them if in the public interest. At the same time it should be emphasized that no national securities exchange which desires to set standards for its members higher than those prevailing in the over-the-counter market would be prevented or discouraged from doing so.

The Commission believes that the establishment of qualification standards, in conjunction with the requirement of membership in a self-regulatory body, will measurably simplify regulation and improve investor protection. Enactment of these provisions will result in better qualified persons, rather than more policemen.

As a supplement to strengthening entrance requirements through the medium of the self-regulatory agencies, the Federal bases for disqualification of brokers and dealers would be expanded to a limited extent by section 6(b) of the bill, so as to conform with the provisions recently approved by the Congress in the 1960 amendments to the Investment Advisers Act of 1940. These new disabilities would include not only offenses and injunctions involving securities transactions or the securities business, but would also cover other types of financial offenses which equally reflect upon a person's suitability to handle other people's money.

In addition, the bill would make a failure reasonably to supervise employees a basis for disciplinary action against a broker or dealer or supervisor. The Commission has consistently held that brokerage firms and their principals have a duty to supervise and on numerous occasions has stressed the necessity for adequate supervision as an essential key to maintaining proper standards. The Report of the Special Study documented the damage that can result to investors from its absence, particularly in the case of a large firm with branch offices scattered throughout the country. The proposed amendment will make this important supervisory responsibility explicit on the face of the statute and set express guidelines for its fulfillment. This codification becomes more important in view of the proposed authority for the Commission to proceed directly against individuals.

D. COMMISSION DISCIPLINARY CONTROLS OVER BROKERS AND DEALERS

The Report of the Special Study pointed out the rigidity and artificiality of the present statutory scheme for disciplining violators, in neither providing for direct action against individual wrongdoers, nor expressly authorizing useful intermediate sanctions against a firm short of revoking registration. Section 6(b) of the bill would add needed flexibility to the Commission's disciplinary powers to overcome these limitations.

At the present time, if an individual connected with a securities firm violates the law without the approval—or the knowledge—of his employer, the Commission can take disciplinary action only by a proceeding against the entire firm. This approach, possibly involving many persons wholly innocent of the violations in question, is awkward and may be unfair. For this reason, individuals may sometimes not be properly disciplined. Accordingly, section 6(b) would permit the Commission to act directly against offending individuals, where that course is appropriate, in lieu of proceeding against the entire firm. The power of the NASD so to act would also be clarified. Of course, this section would not in any way reduce the responsibility of a firm to supervise its employees—an obligation expressly recognized, as already discussed, in the bill.

Section 6(b) would also provide needed flexibility by authorizing the Commission to impose sanctions intermediate to putting a firm out of business. Short of such revocation, the Commission could temporarily suspend or censure. At present the Commission has only three alternatives: it may revoke registration and expel a firm from any exchange or association of which it is a member; it may, at the other extreme, impose no sanction at all; the only intermediate sanction is a suspension of membership in the NASD or an exchange if the firm happens to be a member. The effectiveness of a suspension from an exchange or the NASD as a meaningful sanction varies considerably in accordance with a firm's business and its reliance for profits upon professional price concessions from members of an exchange or securities association.

Another aspect of present law which dilutes the effectiveness of Commission regulation is the exemption from registration for brokers and dealers doing an exclusively intrastate business but who use the mails or instrumentalities of interstate commerce to effect purchases and sales. This narrow exemption from registration would be eliminated by section 6(a) of the bill. To qualify for the exemption, a broker must deal not only with customers who are exclusively within a State, but he must deal exclusively in securities originating in the State. Information obtained in the course of investigations indicates that intrastate brokers and dealers quite frequently overstep these restrictions and thus involve themselves in inadvertent—or willful—violations of Federal laws. There are several reasons why the Commission believes this exemption should be eliminated.

First, the Congress has imposed upon the Commission statutory responsibility for the conduct of these intrastate brokers and dealers in various important respects, including the enforcement of the antifraud provisions and the financial responsibility requirements of the Exchange Act. However, the Commission

lacks means adequate to discharge these responsibilities, since it does not learn of the existence of these brokers except as a result of a complaint and, furthermore, it has no authority to require them to keep books and records. This leads to the anomalous result, for example, that intrastate firms are subject to the capital requirements prescribed under the statute but are not required to keep any records as to how much capital they have. As a result of these handicaps, the Commission must devote an amount of time and effort to fraud investigations involving intrastate broker-dealers that is out of proportion to their number and importance.

Secondly, these intrastate firms are wholly outside the scope of the pattern of self-regulation, which is otherwise such a significant part of the statutory scheme. Unless the present exemption is deleted from the statute, the enactment of H.R. 6789 will result in the establishment of minimum standards of qualification for all broker-dealers except those in the intrastate category.

Thirdly, when an intrastate broker-dealer restricts himself to the permissible area contemplated by the exemption, he is strictly limited in the securities which he may recommend and sell to his customers. For example, he may not be able to deal in any securities listed on the New York Stock Exchange. It is unfortunate that any broker-dealer is so limited since the very securities that he cannot recommend might be those most suitable for his customers.

Finally, if the Commission suspends broker-dealer registration for a limited period, a firm should not be able to minimize the impact of this suspension by conducting an exclusively intrastate business during the period specified.

The only feasible way to manage these problems is to require registration of those intrastate broker-dealers who use the instrumentalities of interstate commerce in their business. Registration will allow the Commission to discharge the obligations already imposed upon it by the Congress. At the same time, it should be made perfectly clear that the repeal of this exemption in no way interferes with the States' regulation of broker-dealers. Section 28(a) of the Exchange Act explicitly reserves State jurisdiction in these areas and this philosophy should and would apply to the intrastate broker-dealers—as it does to interstate broker-dealers.

Section 6(b) would dispense with proof of the use of the mails or interstate facilities in the case of Exchange Act violations by Federally registered brokers or dealers. I want to emphasize that the primary purpose of this change is not to expand our jurisdiction over registered broker-dealers, which is already comprehensive, but rather to relieve our enforcement staff from the essentially useless task of collecting envelopes or other evidences of the use of the mails or interstate facilities in connection with particular transactions. The amendment will thus enable us to use our resources more productively and eliminate unnecessary expense to the taxpayers.

The use of the mails or facilities of interstate commerce has been viewed by the Congress as a basis for requiring registration by broker-dealers with the Federal Government. Once registration has been effected, there is no constitutional necessity or little good reason why the Commission's power to discipline broker-dealers for violations of the securities laws should depend upon the fact that Federal instrumentalities were utilized in the particular unlawful transactions. There are numerous precedents for this position in the securities acts, including sctions 7, 8, and 16(b) of the Exchange Act. It should here be emphasized that dispensing with technical proof of jurisdiction in connection with particular transactions does not affect reliance on the Interstate Commerce clause as the basis for Federal registration of broker-dealers. Registration would be required only if a broker-dealer makes use of interstate facilities.

Section 6(b) will not place the Commission much further into the regulation of intrastate transactions of registered broker-dealers than it already is. Various general regulations of the conduct of the business, such as the bookkeeping rules, the margin rules and, as a practical matter, the capital rules apply whether particular transactions are interstate or intrastate, and whether or not the mails or interstate instrumentalities are used in them. Members of exchanges are subject to certain provisions merely because of their status as such; any transaction on an exchange is subject to Commission jurisdiction, even if all of the parties reside in the same State, since a national securities exchange is itself a facility of interstate commerce. More significantly, any use of the mails invokes our jurisdiction even if the addressee lives across the street. Broker-dealers use the mails in most of their transactions, local or otherwise, if only to send out confirmations, and the great bulk of their activities thus comes within our jurisdiction. Thus, as I stated, the primary effect of the amendment is to relieve us of the burden of collecting evidence.

E. AMENDMENTS WITH RESPECT TO REGISTERED SECURITIES ASSOCIATIONS

In addition to those fundamental amendments already discussed which concern the NASD—required membership in a self-regulatory agency and the establishment of qualification standards—the Commission is also recommending a series of proposals designed in a few respects to clarify or strengthen present law with respect to self-regulatory associations.

First, an increasing scope for responsibility by the NASD is reflected in section 7(a)(6) requiring its adoption of rules designed to produce fair and informative quotations of over-the-counter securities. The section is intended to clarify the NASD's authority in this area and further to impose upon it a responsibility to act. It is not a resolution of the problems affecting the over-the-counter quotations, but a means for dealing with some of these problems.

Secondly, section 7(c) would shorten from 60 to 30 days the time for appealing to the Commission from disciplinary action taken by the NASD or its denial of membership. This reduction will expedite Commission review proceedings and still allow ample time for appeals. This section also provides that the Commission may order, after a hearing, that an appeal from an NASD disciplinary action will not stay the judgment of the NASD pending final decision on review by the Commission. At present, an appeal automatically operates as a stay. It is contemplated that this new power to lift the stay would be sparingly employed; however its use would be proper where an appeal is clearly taken for delay and injury to the public should be prevented pending Commission action.

Finally, under section 7(a)(1), the NASD would be authorized to adopt rules, subject to Commission approval, which would permit exclusion from its membership of persons who have been suspended or expelled from an exchange for violation of any exchange rules. It is anticipated that only serious misconduct of a nature affecting the protection of investors would be grounds for exclusion and any such action would be subject to Commission review. This section would resolve a problem existing primarily between the NASD and the New York Stock Exchange with regard to the collateral effects of the latter's disciplinary proceedings.

In concluding I would again note that H.R. 6789 is in response to a congressional directive—originating in this committee—to the Commission to evaluate the adequacies of present investor protection. That directive has produced a searching and intensive inquiry by the Commission's Special Study of Securities Markets. It also resulted in a firm conviction on the part of the Commission that the present statutory structure of the securities acts requires improvement in significant respects. The provisions of H.R. 6789 represent such a strengthening and the Commission strongly recommends its enactment.

Mr. STAGGERS. Since we have just heard a quorum call, we will have to proceed to the floor of the House.

The committee will now recess, to reconvene at 2:30, or as soon thereafter as possible. If it develops that we cannot proceed with the hearing, we will so inform you. You will resume the stand for questioning as soon as we reconvene.

Mr. CARY. Yes, sir.

(Whereupon, at 12:20 p.m. the subcommittee recessed, to reconvene at 2:30 p.m. the same day.)

AFTERNOON SESSION

Mr. STAGGERS. The subcommittee will come to order.

When we recessed at noon, Mr. Cary was giving his testimony. I wish you would continue with your presentation, Mr. Cary.

STATEMENT OF WILLIAM L. CARY, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION—Resumed

Mr. CARY. Mr. Chairman, as I understand, you would prefer, and your committee would prefer, that I proceed with my second statement now, which is, as I indicated earlier, a broader statement, dealing

really with the origins of the Special Study, the nature of the report and its recommendations, our views with respect to it and our implementation of it.

Mr. STAGGERS. You may proceed.

Mr. CARY. May I say that, although this is not as formidable a document as the preceding one, I think I should present it, too. But I think also that I might be able to cut down the first part of it because it is so familiar to this very committee.

I know that the subcommittee has a special interest in the Special Study of the Securities Markets and its impact, so I will review the events leading up to the study, our reactions to the report, the progress made in implementing it, and our program for the future for further action.

On the first and second pages of my statement, Mr. Chairman, I have given the background of House Joint Resolution 438 to which you referred this morning. There is a discussion of the hearings, but since I am before this very committee at which those hearings were held, I will not read it at this time but have this inserted into the record later.

Needless to say, I have mentioned there some of the enormous facts of change in the securities markets, the substantial increases, for example, in branch offices and registered representatives, and the enormous expansion of the over-the-counter market which, as I say at page 2, increased about 700 percent in 12 years from an estimated $4.9 billion in 1949 to $38.9 billion in 1961.

Going on from there in my statement, going to page 3, we move on to the need for House Joint Resolution 438. Again, this has been discussed before this very committee and, therefore, I will not go over that in detail and read it. I do note there the turbulent market which existed, the existence of "hot issue"; "fails" to receive and deliver stock certificates; the fact of injunction actions and criminal referrals were at alltime highs.

I also refer at that time to the illustration, as I put it at the top of page 4, of a dramatic illustration of a breakdown in the securities markets was contained in the Commission's staff report on the American Stock Exchange.

Then I discuss the *Re* case at the bottom of page 4 and also illustrate instances of illegal conduct in major cases that we were involved in, at page 5, including the *United Dye & Chemical Corp.* and the *Gulf Coast Leasehold Corp.* cases, both of which have been decided in recent times.

Then at page 6, I refer to the fact of examples of the failure of supervision.

Mr. STAGGERS. Mr. Chairman, I believe some of these things that you are skipping over are very important to the committee. I do not think it would hurt to review them. I believe they ought to be given fairly fully for the benefit of not only this committee but others interested.

I think these items are very pertinent to the hearings and to the decisions that have been reached. I think they ought to be fully gone into.

Mr. CARY. I will be very glad to go over that, but I didn't know whether I should take the time of your committee.

Mr. STAGGERS. I think it would be well worth the time. It is an important subject. Having spent this much time, I think we ought to take a little more time and discuss it fully.

Mr. CARY. Very well, sir.

I will start on page 1, discussing the background of the House joint resolution of this very committee and the hearings before your committee.

On June 1, 1961, Congressman Peter F. Mack, Jr., then chairman of your subcommittee, introduced House Joint Resolution 438, "the Mack resolution," authorizing and directing the Commission "to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations."

In his accompanying address before the House of Representatives Congressman Mack remarked:

> For some time I have been concerned with the widespread evidence of speculation, and of apparent manipulation in many instances, appearing in our established securities exchanges and in our over-the-counter markets. * * *
>
> It has seemed to me to be high time to review these rules governing the activity of various securities markets to see whether they are adequate to protect investors, and to determine just how they are being administered by the stock exchange and the over-the-counter association.

On June 27, 1961, your subcommittee commenced hearings on the Mack resolution. No one appeared in opposition, the resolution was strongly endorsed by the Commission and supported by industry representatives.

In the Commission's statement to the subcommittee during the hearings, we referred to certain developments in the securities markets which had dramatically affected their structure and operation.

Mr. HARRIS. That was in 1961?

Mr. CARY. That is correct, sir.

Mr. HARRIS. It has been over 2 years since that time. Has there been any noticeable change?

Mr. CARY. The trading volume? Mr. Chairman, on the trading volume today I will ask one of my colleagues to speak on that because I am not sure enough. Public participation is a different kind than it was then.

As I indicate a little later, the kind of public participation that then existed was very broad participation. Everybody in the market was engaged in purchasing hot issues and things of that kind.

It is true that the market is at the same level, perhaps, as it was at that time but the same group of people are not in the market at the same level as they were at time. Now, that is one point.

Mr. HARRIS. I do not want to get you off of your discussion. We will go into it later.

Mr. CARY. I will ask Mr. Saul or Mr. Loomis if they can speak as to trading volume.

Mr. STAGGERS. Would you identify him for the record?

Mr. CARY. Mr. Ralph Saul, Director of the Division of Trading and Markets.

Mr. SAUL. Mr. Chairman, I think in the over-the-counter market there is every evidence that there has been quite a noticeable decline in volume. There is nothing like the activity there was back in the spring of 1961, at the time of the House resolution.

On the exchanges, there is every indiciation that volume is at fairly high levels, in fact at levels comparable to those in 1961, but there are some indications, as the chairman indicated, that the type of participant in the market tends to be more of a professional participant and there seems to be less speculative interest in the market.

Mr. CARY. As I indicated in the statement, two were of paramount importance, this rapid upsurge in trading volume and public participation, and broad and related changes in the established methods of distribution and marketing of securities.

Thus, there had been substantial increases in branch offices and registered representatives.

One of the most striking signs of change was the enormous expansion of the over-the-counter market. Sales of over-the-counter corporate stocks (excluding sales of mutual fund shares and syndicated distributions) increased about 700 percent in 12 years—from an estimated $4.9 billion in 1949 to $38.9 billion in 1961.

The Commission followed this fast-moving and continuous growth and attendant changes, concentrated its efforts on meeting the immediate regulatory and enforcement problems, and conducted studies of particular aspects of the markets. But an adequate and complete examination was impossible.

As we stated at the time to the subcommittee, an essential purpose of the resolution was to afford the Commission—

> enough opportunity to back away and look at the problems * * *. A thorough study of the over-the-counter market and of the exchanges would be desirable at this time, and our present budget is not enough to support it. The constant danger in our Commission is that, with market activities and flotations at an alltime high, we become so overwhelmed with immediate problems that we are virtually forced to concentrate all our funds and manpower upon them and cannot do enough long-range planning.

Now I go to the next point, the need for House Joint Resolution 438.

The timeliness and need for a broad and full-scale review of the adequacy of investor protection was clear. This was a turbulent market in which a record number of companies, many highly speculative, were going to the public for financing.

May I interpolate at that point a further answer to Chairman Harris' question, that the number of companies going to market at the present time is very substantially below that of 2 years ago.

The "hot issue" was prevalent: initial trading markets for many new issues reflected an extraordinary premium over the offering price. Trading volume was soaring, accompanied by noticeably high "fails" to receive and deliver stock certificates.

The very active markets were accompanied by a peak in the Commission's investigatory and enforcement functions. Injunction actions and criminal referrals to the Department of Justice were at alltime highs.

A most dramatic illustration of a breakdown in the securities markets was contained in the Commission's staff report on the American Stock Exchange. The Commission's investigation underlying this report had commenced prior to the introduction of the Mack resolution, soon after the Commission had expelled the leading specialist firm of Re & Re from that exchange.

The subsequent staff report, released on January 6, 1962, confirmed the need for a broad reassessment of the existing regulatory structure

in the securities markets as required by the Mack resolution. While the report was not intended to cast any reflection on the basic soundness of the majority of issues of securities traded on the American Stock Exchange, or on the importance of the exchange itself as a marketplace, it was critical of many events and practices on the exchange and raised serious questions which called for prompt and vigorous action.

For example, the two leading specialist firms, who specialized in stocks involving almost 15 percent of the exchange's volume, were found to have engaged in numerous illegal and highly improper activities.

The two Re's were subsequently convicted for their manipulative operations involving the stock of Swan-Finch; this was just one of their many massive illegal distributions, largely on the exchange. As the Commission stated in its opinion expelling the firm from the exchange:

> It is impossible to calculate in dollars and cents the extent to which the unsuspecting investing public was defrauded by reason of respondents' manipulative activities.

The principals of Gilligan, Will & Co., the other prominent specialist firm, were suspended by the exchange for 3 and 1 years and barred from being specialists for 5 years. (The main partner of this firm resigned from the exchange just prior to the commencement of the Commission's investigation.)

The very fact that the practices criticized by the report were found to exist in the second most important national exchange emphasized the necessity of obtaining and evaluating overall information as to current distribution and trading practices throughout the markets.

Problems of illegal conduct were not limited to the American Stock Exchange. The longest criminal trial in the history of the Federal courts concluded on February 4, 1963, with the conviction of 17 defendants for "boilerrooming" the stock of United Dye & Chemical Corp. An integral part of this conspiracy was the manipulation of the price of the stock on the New York Stock Exchange.

As another example, the prosecution of the *Gulf Coast Leasehold Co.* case involved one of the largest over-the-counter manpulations and fraudulent distributions, and was concluded on August 7, 1963, with the conviction of nine defendants. The investigations underlying these very complex cases commenced around 1955.

The Report of the Special Study of Securities Markets also confirmed the existence of significant violations of applicable legal and self-regulatory standards. There are examples of failures by large firms to exercise appropriate supervision over their branch offices, with the result that these offices engaged in securities dealings of a highly questionable or illegal nature.

Cases are cited by the report where brokers used fictitious quotations to aid in the sales of over-the-counter securities. The report moreover, notes numerous instances in which distributions of new securities were accompanied by unethical or illegal practices.

These types of abuses and misconduct were an important part of the congressional concern prompting the enactment of House Joint Resolution 438. Those abuses were, of course, only one aspect.

Equally if not more important was the idea that, after 30 years and in light of the significant changes in the markets, a broad study was essential if only to explore and evaluate the many new developments, in the depth and with the precision that a special study alone could provide.

As was stated on the Senate floor during consideration of the joint resolution:

> The words "study and investigation" as they are expressed in the resolution—and the order in which they appear—are very significant. Their usage indicates that the Securities and Exchange Commission would be authorized not only to search for abuses in present laws and regulations but also, through a comprehensive study to accumulate the facts and professional opinions which would serve as a firm basis for future legislation designed to offer the investor more substantial protection.

An examination of this nature was one of the important aims and achievements of the Special Study. As a result of the study, for the first time the facts are now available to adequately comprehend and evaluate many vital aspects of the markets, including the interrelationships among the trading markets, the impact of the New York Stock Exchange minimum commission rate schedule, and the nature of retail executions in the over-the-counter market.

We now have an overall view of the operation of self-regulation, a subject which this subcommittee emphasized in the resolution authorizing the study.

To take another illustration: Congress thought it highly important that excessive credit not be used for speculation in the stock market. Accordingly, the Congress gave the Federal Reserve Board the authority to set margin requirements with respect to the purchase of securities as a part of the Board's general responsibility for credit control in the economy.

The Report of the Special Study has raised some very important questions about the present statutory pattern of credit regulation as it affects the stock market. We recognize here the primary authority of the Federal Reserve Board and will not initiate any action. But I believe that the Board has found the Study Report a sound basis for analyzing the need for change in this critical area of the securities markets.

The enactment of House Joint Resolution 438: Following the subcommittee's hearings on the resolution, in a unanimous report recommending its approval, the full Committee on Interstate and Foreign Commerce stated:

> During recent months the president of the New York Stock Exchange has issued two very firm warnings against speculation in the stock market. The country's largest brokerage firm has run a dozen newspaper ads urging investor caution, and many other brokerage houses have alerted employees to the danger of uninformed public speculation. The National Association of Securities Dealers has written to all members expressing concern over the very large total of outstanding undelivered transactions. The Chairman of the Securities and Exchange Commission has stated that there have been evidences of a substantial amount of manipulation and that they have more manipulation cases in various stages of proceedings than ever before. The Commission has initiated an investigation of the American Stock Exchange to determine whether additional rules or laws are required to insure proper operation of the exchange.
>
> * * * Since the market collapse which led to the enactment of the Federal securities laws, there has been a rebuilding of public confidence in the securities markets as a result of both efforts at self-regulation by the industry and the

enactment of the statutes and their administration by the Securities and Exchange Commission. The maintenance of this confidence is most essential. There has been a great growth and increased activity in the securities markets. It is important to be informed as to whether at this time in the light of changed market conditions the investing public is afforded the protection which was envisaged in the passage of the original legislation. What new statutes or rules are needed? What new unregulated areas of the securities markets need regulations? What rules need change?

On September 5, 1961, House Joint Resolution 438 was enacted as section 19(d) of the Exchange Act. As originally enacted, the Mack resolution provided for a reporting date for the study of January 3, 1963. On July 27, 1962, after it became apparent that the scope of the undertaking made it impossible to comply with the original reporting date, H.R. 11670 was enacted as Public Law 87–516, to extend the reporting date to April 3, 1963. For essentially the same reasons which required the extension, the Commission did not fully meet the revised reporting date.

As you know, it did come out in three segments.

The first one was April 3, and the second one was in July, the last one was in August of this year.

Now, going on into the Special Study of Securities Markets:

To carry out the congressional mandate, the Commission established a separate group of approximately 65 persons designated the Special Study of Securities Markets, with Milton H. Cohen as Director. In addition to a number of the Commission's regular employees, the study was staffed by many persons from outside the agency, including lawyers from private practice, economists, university professors, and personnel from other Government agencies.

It was decided to give the study freedom to analyze and point out problems as they appeared to it. As we stated in our first letter of transmittal:

* * * in this respect, the judgments, analyses, and recommendations in the report are those of the Special Study and not the Commission.

In noting the independence of the study group, I want to make one point absolutely clear: we in no way divorce ourselves from the report. This was not the technique of arranging for others to produce a report, making it public, and then disavowing it when criticized. This was not our intention, nor what has happened. We worked very closely with the study throughout and went over the entire report. We have publicly stated our position with respect to each of the study's recommendations.

There were certain areas where we were not prepared to accept at the time a recommendation as made and indicated the need for further thought and examination. Yet we strongly endorsed the general soundness of the report and expressed our conviction that it was a highly thorough, thoughtful, and responsible document. We have already acted upon it in very vital ways—which I shall detail later. Suffice to point out here that our legislative program, to which we assign such high priority, is a product of recommendations of the Special Study Report.

We believe the study fully justified the confidence entrusted in the Commission by the Congress in authorizing an examination of the securities markets. At the end of 1962, Americans had invested almost $450 billion in corporate securities; as of early 1962, it was estimated

that over 17 million individuals held shares in publicly held corporations. In the light of these figures, an audit of the markets—which has cost $950,000—appears thoroughly justified, particularly considering the important results which have already flowed, and which will flow, from the study report.

Now if I may, I would like to go into general comments on the report of the Special Study of Securities Markets.

The report of the study was transmitted to Congress in three parts: The first segment consisting of chapters I, II, III, IV, and IX, on April 3, 1963; the second segment with chapters V, VI, VII, and VIII, which primarily dealt with the markets as a whole, the exchange market and the over-the-counter market, on July 17, 1963; and the third and final segment containing chapters X, XI, XII, and XIII on August 8, 1963.

In our transmittal letters which accompanied delivery to Congress of each segment of the report, and in our letters giving our specific views on the study's recommendations, we presented our position on the findings and recommendations of the study. As a general proposition we commented as follows on the state of the markets:

> 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. (Letter of transmittal, August 8, 1963.)
>
> At the outset we emphasize that, although many specific recommendations for improvements in rules and practices are made in the Report of the Special Study, the report demonstrates that neither the fundamental structure of the securities markets nor of the regulatory pattern of the securities acts requires dramatic reconstruction. The report should not impair public confidence in the securities markets, but should strengthen it as suggestions for raising standards are put into practice. Serious shortcomings are apparent and the report, of course, has concentrated on their examination and analysis. Yet it is not a picture of pervasive fraudulent activity and in this respect contrasts markedly with the hearings and findings of the early thirties preceding the enactment of the Federal securities laws. The study confirms the strength of those laws and the heightened sense of obligation of the financial community.
>
> At the same time the report makes very clear that important problems do exist, grave abuses do occur, and additional controls and improvements are much needed. The tremendous growth in the securities markets over the past 25 years, and most particularly the increased public participation, imposed strains on the regulatory system and revealed structural weaknesses. Neither the securities acts, the Commission, nor the industry itself fully anticipated the problems arising from the entry of unqualified persons, the spectacular development of the over-the-counter market, the vast number of companies going public for the first time, or a variety of other striking changes. (Letter of transmittal, April 3, 1963.)

I would like to underline these points.

First, the picture of the markets generally is one of basically strong institutions subject to specific weaknesses. There is a sound framework within which to effect improvements—a framework in large part attributable to the Federal securities laws and the efforts of the financial community since their enactment. In many cases, necessary improvements should follow practices already observed by responsible leaders of the industry.

Secondly, the axioms of securities regulation embodied in the securities acts—namely, disclosure and industry self-regulation—have been found in most instances to be effective tools. The self-regulatory agencies have a primary role with regard to controls over the markets and broker-dealers. The Report of the Special Study encompasses

an analysis of the adequacy of their rules. The Commission agrees with the study 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." As to the disclosure policies of the present statutes, the report states:

> The Commission's administration of the registration provisions and related exemption provisions of the Securities Act has been one of its most outstanding achievements, and the statute itself has proved generally adequate and workable.

Thirdly, side by side with this general strength, there are numerous shortcomings in the market which must be remedied. The study did not, and could not, measure these numerically. Thus, the study did not—and could not possibly—determine that a certain percent of all transactions in the over-the-counter market were all right or were fraudulent. Essentially it examined possible problem areas, analyzed applicable regulatory and industry controls, and demonstrated where those controls were deficient.

For example, in the area of investment advice, the report points out how irresponsible market letters can lead to incalculable damage to investors. It graphically demonstrated the need for better disclosure practices in the case of over-the-counter companies. It is to the shortcomings disclosed that we and the industry are now directing ourselves. Each gap that is closed, each fraud that is prevented, each standard that is raised—all of these will make for more fair, honest, and orderly securities markets. And that, to be sure, is our goal—to have securities markets of integrity so that there will be a flow of capital into American industry, capital vitally needed for our economic growth.

Now, Mr. Chairman, I would like to move on to the importance of the Special Study of Securities Markets.

Before detailing our progress on the implementation of the study report, I would like to summarize briefly the Commission's views on the importance of the report.

First, the report provides, in an organized and complete fashion, the facts about the securities markets. For the first time we have a full-length portrait of the current over-the-counter market. For the first time we have a comprehensive picture of the impact of the New York Stock Exchange minimum commission rate schedule on reciprocal business practices, on the "third market" (over-the-counter trading in listed securities"), and on the regional exchanges.

It is essential to have this information to identify emerging prolem areas and in order to evaluate regulatory proposals.

The report also presents a detailed catalog of industry practices. Where these practices support principles of fair dealing, they can be encouraged. For example, in the area of supervision, the study describes in detail the elaborate control procedures of certain firms. These procedures can be profitably imitated by others in the industry.

Secondly, and perhaps most important, the report is a springboard for both industry and regulatory action. The report disclosed many serious shortcomings in investor protection, of varying kinds and degrees. Its 175 recommendations embody a far-reaching and important program. The Commission will utilize its full powers and resources to assure that this program is carefully examined, and except where undesirable or impractical, implemented. As this is done,

standards in the securities markets will be raised and investor protection significantly improved.

Part of the process of improvement became evident after this subcommittee's hearings authorizing the Special Study and while the study was in progress. This fact reflects an important point about the study; it provided an opportunity and stimulus for the industry to reexamine itself, to conduct its own special study. Thus, many important and worthwhile developments have already occurred. I would like to note a few of these.

Mr. HARRIS. Mr. Chairman, I do not want to provoke any long discussion you might have until you conclude, but the 175 recommendations in the report are outlined in the reports and categorized as such?

Mr. CARY. Mr. Chairman, they are. We have also arranged to have this part V printed under your auspices, which contains all the recommendations. They are in the reports themselves as you go along chapter by chapter and then they are totally incorporated in this part V.

Mr. HARRIS. What page do they start on in part V?

Mr. CARY. Take part V, for instance, Mr. Chairman, and I suppose the first point at which we have any real recommendations is as to chapter II, which begins at page 37. Then you will find that the recommendations themselves are in boldface type, beginning, for example, at page 45 of part V. That would be the recommendations with respect to that particular segment.

Then you go on with chapter III, and similarly at the end are, in boldface type, the recommendations related to that particular area of subject matter.

Mr. HARRIS. Mr. Chairman, I wanted that to be noted for the record at this point.

I would like to ask that, for reference purposes, the report be received for the files of the committee so they may be incorporated in these hearings by reference.

Mr. STAGGERS. Without objection, that may be done.

Mr. CARY. Thank you, sir.

I will resume with my reading of the statement, Mr. Chairman.

First in order of importance is the reorganization of the American Stock Exchange. At the time of the enactment of the Mack resolution, the Division of Trading and Exchanges of the Commission had initiated an investigation into the American Stock Exchange, which was completed by the Division and by the Special Study. A report on the exchange was publicly released on January 5, 1962. Its comprehensive findings were summarized in this conclusion:

> 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.

In releasing the staff report, the Commission indicated its hope that necessary reforms would be accomplished within the statutory framework of self-regulation. By the time the staff report was released, the American Stock Exchange had already formed a special committee—known as the Levy committee, for its chairman—to conduct an examination of the exchange. The Commission worked with this

committee as well as with the new administration of the exchange, which assumed control early in 1962. Numerous constitutional and organizational changes and other actions stemming from the staff report and the work of the Levy committee were carried forward by the exchange community itself with active encouragement from and in consultation with the Commission.

The situation at the American Stock Exchange has dramatically improved in the last year and a half. A staff system has been substituted for the self-perpetuating standing committees of exchange members.

The exchange's capacity to enforce adequate self-regulation has been strengthened by the addition of nearly 60 new employees, more than half of whom are on the professional, supervisory, and executive levels.

The exchange has also adopted many significant rule changes, including an increase in the minimum capital requirements for specialist firms and a requirement that specialists report transactions in the accounts of public customers.

New listing and delisting standards put into effect in 1962 led to the removal from listing of some 62 companies which failed to meet the higher standards.

Finally the exchange's listing agreement was amended to obligate companies to solicit proxies for all meetings of stockholders and to publish earning reports on a quarterly basis.

The exchange took disciplinary action against various members and allied members whose activities were discussed in the staff report. In the opinion of the Commission, the exchange has performed this duty with dispatch and thoroughness. Some 15 major proceedings have been concluded, a number resulting in expulsion of members or suspensions from membership for long periods. Only a few weeks ago the last major action which arose out of the Commission's investigations was concluded and the exchange suspended a former floor trader from membership for 3 years.

In summarizing this program of reform the study report stated:

> The exchange has thus undergone a major constitutional and organizational reform. 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.

Improvements made by the New York Stock Exchange have been broad in scope, substantial in number and quite significant in effect. In the vital area of qualification standards, written examinations are now required of individuals desiring to become allied members, floor members, specialists, or odd-lot brokers, and additional requirements have been added for the registration of salesmen.

Moreover, new and more stringent standards for approval of branch offices and branch office managers have been adopted. For the first time these offices are being inspected to review selling activities and the adequacy of supervision.

The substantive rules with respect to market letters have been materially strengthened and the procedures for exchange review of these materials have been improved.

The staff of the important department of member firms have been substantially increased. The board of governors of the exchange has recently decided to assume jurisdiction over the odd-lot differential.

The National Association of Securities Dealers started its self-examination process quite early. As the study was getting underway in late 1961, the association's board of governors ordered a complete review and analysis of the existing bylaws, rules, and interpretations. Although this work is still in progress, material strengthening of the association's rules and policies is expected to result from it. The NASD has also increased its staff and strengthened its surveillance programs.

At the same time more disciplinary actions were initiated and decided in 1962 than in any other year.

These new activities have required significant budgetary increases.

Thus, the budget for fiscal 1964 (over $3 million) provides for an 18-percent increase in expenditures over fiscal 1963 and a 50-percent increase over fiscal 1962. It should be noted that substantially all of the NASD's budget is allocated to enforcement and regulatory matters.

In addition to the self-regulatory agencies, th broker-dealers themselves have been taking steps to improve their procedures.

In February 1962, the president of the New York Stock Exchange stated:

> There probably never has been a time when so many firms throughout the securities industry were spending so much effort and money on the selection and training of personnel.

The president of the Investment Bankers Association in November 1962 similarly commented:

> Investment banking firms are tightening their operations in large part because of the investigation of the securities markets by the Securities and Exchange Commission. This is particularly noticeable in the area of training and indoctrinating new salesmen, and supervision, and the establishment of controls.

I would like to submit for the record a statement detailing the many changes which have occurred in the industry since the institution of the congressional hearings which authorized the Special Study. This is a long document of 21 pages, Mr. Chairman, entitled "Current Industry Developments."

Mr. STAGGERS. You may submit it for the record.

(The document referred to follows:)

CURRENT INDUSTRY DEVELOPMENTS

THE OFFICIAL SELF-REGULATORY BODIES (THE EXCHANGES AND THE NASD)

Because of the quasi-public standing of the exchanges and the National Association of Securities Dealers and their large memberships, the changes effected by them have had the most pronounced impact on the industry. The recent developments in connection with these organizations are treated here.

AMERICAN STOCK EXCHANGE

General

The program of reform commenced in October 1961 with the appointment of the Levy Committee formed to make a comprehensive review of the organization, rules, policies, and procedures of the exchange. The Commission worked with this committee as well as with the new administration of the exchange, which

assumed control in early 1962. Numerous constitutional and organizational changes and other actions stemming from the Commission's staff report of January 1962 and the work of the Levy Committee were carried forward by the exchange community itself with active encouragement from and in consultation with the Commission.

Organization and administration

One of the most important aspects of the reform program involved material revision of the exchange's governing instruments. A new constitution patterned largely after that of the New York Stock Exchange has been adopted. Under the new constitution, the board of governors has become the sole policymaking body. The office of the president has been assigned a more important role and the standing committee system which was criticized by the staff report has been eliminated. The new constitution also has changed the methods of selecting members of the board of governors. These are designed to prevent a recurrence of specialist domination of the board and to give some board representation to members located outside the metropolitan area of New York City.

The staff of the exchange has been augmented by the addition of 60 new employees, more than half of whom are on the professional, supervisory, and executive levels. Two new divisions have been established. The new division of market procedures will be responsible for activities on the trading floor, and ticker and quotation operations. The new division of office procedures mainly will be concerned with arbitration, member and registered representative admissions and administration of exchange rules with respect to capital, margin accounts, and commission rates. Both of these divisions will be in the charge of an exchange vice president.

Specialist regulations

The exchange has devoted considerable effort to tightening its specialist regulations. To begin with, the minimum capital requirements for specialists have been increased so that each specialist must now maintain a cash or liquid asset position of $50,000 or an amount sufficient to assure a position of 10 trading units in each security in which he is registered. Specialists now also are required to report to the exchange transactions with public customers in securities in which they are registered and their participation in profits and losses derived from joint accounts has been restricted so that now a member firm may not participate in such profits unless a principal of the firm is registered and active at the post as a specialist in such joint account.

A market surveillance team now scrutinizes trading activity daily. And statistics have been developed to help the exchange allocate new listings to specialists on the basis of the need for sound and orderly markets. In this connection, detailed records of past performance are an important consideration.

Listing and delisting standards

The listing and delisting requirements for issuers have been upgraded. Flexible standards have been replaced by specific listing and delisting requirements which focus on a company's financial status and share distribution. These new standards have resulted in 57 issues of 53 companies being delisted since April 1962. Listed companies now are also required to solicit proxies for all meeting of shareholders and to publish earnings reports on a quarterly basis.

Admission and qualification standards

The exchange has taken steps to raise member and registered representative qualification and entry standards. As a part of the joint examination program entered into with the NYSE and NASD, registered representatives are given a new and stiffer examination. And a proposal to test partners of new member firms is under consideration. The test would cover such subjects as industry ethics, standards, and rules.

Disciplinary proceedings

The exchange has taken disciplinary action against various members and allied members whose activities were discussed in the staff's January 1962 report. One specialist mentioned in the report was suspended from exchange membership for 2 years. Two partners in the specialist firm of Gilligan Will & Co. whose operations were dealt with at some length in the report were suspended and fined. A third partner was fined and three other exchange members who operated joint specialist accounts with the firm were "severely censured," and one of these members in addition received a fine. The exchange has 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 persons were suspended from exchange membership and one was fined. Exchange members also were disciplined in connection with circumstances arising out of the *Re* case. A partner in one firm was expelled from allied membership and two other partners from the same firm were fined. A partner in another firm was suspended from regular membership and fined in connection with another phase of the *Re* matter.

NEW YORK STOCK EXCHANGE

General

The exchange has announced that it is making a detailed examination of the market study report. In this connection five committees of the members have been appointed to consider questions raised by the report in the areas of volume discounts, rate, structure, and level of Commission rates and other rate matters; abolution of floor trading, establishment of auxiliary specialists; exchange regulation of the odd-lot differential and other aspects of the odd-lot business; obligations and responsibilities of specialists and adequacy of the present specialist capital requirements, practices of specialists maintaining and servicing public accounts and their "stopping" stock against executable orders, elimination of specialists long-term investment accounts and abolition of the specialists—corporate liaison program; creation of associate memberships, extension of full or partial voting rights to allied members, increased representation of public brokerage firms on the board of governors and other governing bodies of the exchange; limitation of floor governors ad hoc powers; publicity to be given to exchange disciplinary actions; and, the exchange's overall relationship with the SEC and the other self-regulatory bodies. To assist these committees in their work the exchange has retained three outside consulting firms. One, a national accounting firm, will analyze the costs of handling odd-lot transactions. It should be noted here that the board of governors has agreed in principle to regulate the odd-lot differential. The floor trading problems will be looked at by a management consultant organization and a firm of economic consultants, according to the exchange, "will examine present and possible future methods of measuring the effectiveness with which exchange specialists perform their function of endeavoring to maintain orderly markets."

Admission and qualification standards

In addition to the exchange's longstanding program for testing new securities salesmen, written examinations are now also required of individuals desiring to become allied members, floor members, specialists, odd-lot brokers, and main or branch office managers, including assistant and associate or comanagers of such member offices. New and more stringent standards for approval of branch offices and branch office managers have been adopted. New requirements have been imposed in connection with the limited registration program including an increase in the training period from 1 to 3 months. Correspondence courses may no longer be used by salesmen as a substitute for taking the exchange's registered representative qualification examination. And since early 1962, the staff of the exchange has been actively assisting member firms in working out salesmen training programs. In this connection the exchange has prepared, and issued to members, pamphlets on selection and training of salesmen and on their proper supervision. Also a manual and other educational materials are now made available to salesmen as training aids.

Specialists and floor trader activities

The staff of the floor department has been given increased authority in the investigation of floor irregularities. The staff may now proceed on its own initiative and need not wait for, nor rely upon, the floor governors to conduct such investivations. In addition, an examiner-accountant has been employed to visit offices in which specialist and floor trader records are maintained for the purpose of making a more thorough check of their activities, including among other things, inspection of the public customer accounts of specialists. In this regard, specialists are now required to report transactions by their public customers to the exchange. The exchange has also initiated a program of checking the statements of account maintained by specialists and floor traders against their forms which the exchange requires them to file with it.

Department of member firms

This important department has been reorganized. Since January 1, 1962, the department's professional staff has been increased by over 20 percent. Three of the new employees are attorneys assigned special investigative duties and three of the other new employees were added to the staff handling complaints received from the public.

The department now includes as a part of its member examination program on-site inspection of members' branch offices. This is done for purposes of reviewing their selling activities and practices and the adequacy of member supervision over them. Examination of the books and records of individual owners of seats not affiliated with a member firm is now also a part of the department's overall examination program.

Market letter and advertising review

Procedures for reviewing and passing on members market letters and advertising material have been strengthened. The staff reviewing this material has been increased from one employee on a part-time basis to four employees. The cycle for reviewing this literature has been reduced from 2 years to 6 months. One full-time staff employee now surveys directorships, special relationships, and positions in options and stocks when the subject of member market letter recommendations.

The exchange has adopted new rules governing its members' communications with the public. They include, according to the exchange, many of the Special Study's recommendations with respect to statements about research. Under the new rules it is now required that market letters, research reports, and other advertising and sales literature must be identified as to source when prepared by someone other than the member furnishing such materials. The rules further provide that a member which claims it is equipped to provide research services must have a reasonable basis for making such claim. And it is now also prohibited for sales literature of any kind to carry a research department byline or give the impression of originating within a research department, unless it did originate there. The new rules also require projections and predictions be clearly labeled as "estimates"; the avoidance of statements which are promissory, exaggerated, flamboyant, or contain unwarranted superlatives; factual support for making comparisons of one firm's services, personnel, facilities, or charges with those of other firms; and the dating of all sales literature with a special notation where significant information is not reasonably current.

Public complaints

The exchange's public complaint procedures have been modified so that it now immediately advises complaining investors of their right to arbitrate. Under prior procedures such notice was only occasionally given. The exchange now also sends to a complaining investor a copy of the complete answer made by the firm in response to the charges asserted against it. Formerly the staff would delete and edit certain portions of the answering letter before it was sent to the investor.

Disciplinary process

The disciplinary process of the exchange has been changed to allow registered representatives to appeal adverse staff decisions to the board of governors. Registered representatives are now subject to fines for rule violations in the same manner as are partners and officers of member firms ($250 for each violation, maximum at any one time, $2,000).

Customer preferences and rebates and reciprocal business practices

The exchange has acted to curtail customer preferences and rebates and certain reciprocal business practices of its members. Members have been told that prepayments and rebates to customers are rarely justified and that records of such must be maintained. In addition, members have been limited in the kinds of selling materials which they can provide without cost in exchange for Commission business directed by investment companies.

Cooperation with other regulatory agencies

As more fully described in chapter XII.J of the report, the NYSE, Amex, and NASD have made progress in bringing about better coordination of their regulatory activities. As a first step there hase been put into effect a new combined testing program under which new salesmen of firms belonging to the Amex, NYSE, and NASD can qualify for registration with each of these organizations

at a single sitting. These organizations have also agreed to refer complaints from investors to the "agency having primary responsibility" (e.g., if the NASD or Amex receives a complaint pertaining to the handling of an order in an NYSE stock it would be referred to the NYSE).

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

General

Since the commencement of the Special Study the association has been reviewing and analyzing its bylaws, rules, and interpretations. Authorized by the association's board of governors in September 1961 this review, the first in the organization's 24-year history, was designed to have the association self-appraise its own rules and policies at the same time they were being examined by the staff of the Special Study. Although the work is still in progress, material revisions of the association's rules are expected to result from it. The association has also appointed industry committees to review systematically those recommendations of the Special Study pertaining to the NASD and the over-the-counter market.

Industry surveys

In September 1961 just as the Special Study was getting underway the board of governors appropriated $50,000 to have the Wharton School of Finance of the University of Pennsylvania conduct a comprehensive study of the over-the-counter market. This would update the series of studies made by the Wharton School for the association in the early 1950's.

Budget and staff

Budgeted revenues and expenses have increased in recent periods. The budget for fiscal 1964 provides for an 18-percent increase in expenditures over fiscal 1963 and a 50-percent increase over budgeted expenditures for 1962. To meet these additional expenditures the association has made upward adjustments in its assessment and fee schedules. Since 1962 the basic membership fee has been increased by 130 percent (from $65 to $150), personnel fee by 100 percent (from $3.50 to $7), and the two underwriting fees by 60 percent. During this same period the ceiling on assessments has been raised by over 50 percent, from $8,000 to $12,500, and the nonassessment revenue items also have increased, in one instance by as much as 150 percent. In addition, in September 1963 the association announced that members' over-the-counter business for the first time would be included as an integral component of the assessment formula.

In terms of added personnel the 1964 budget provides for 174 employees, an increase of 43 over the number employed on December 31, 1961 and 1962, over the number employed on December 31, 1960. The budget includes provision for 42 member firm examiners, an increase of 15 over the number of examiners authorized in 1961.

Examination program

The examiner staff of the association has been placed under the direction of the chief of examiners, a newly created position. In addition permanent examiner assignments have been made to each of the association's 13 districts. Prior to January 1, 1962, 9 of the 13 districts were without permanent examiners. As a result of these changes the association has been able to obtain broader examination coverage of its membership. Thus, member main office and branch office examinations in 1962 were up 16 percent and 29 percent respectively over 1961. And for the first 10 months of 1963 the number of member examinations has increased by 45 percent over the comparable 1962 period.

Retail quotations

The association's retail quotations practices have undergone numerous changes. The National Quotations Committee has assumed supervision over the activities of the various local quotation committees. Formerly, local quotation committees worked independently of the National Quotations Committee and the executive office.

The association's sponsored retail quotations now are made available on a three-times-a-day basis. Such quotations as late as September 1961 were published only once a day.

The association also has revised its so-called rule of thumb markup schedule used to convert wholesale asked prices to retail asked prices for purposes of newspaper publication. With respect to stocks priced above $25 the new schedule provides for lower markups than those previously in effect.

Companies appearing on the national and regional lists are now required to give prompt public notice of all corporate developments "which may affect the value of the company's securities or affect investors' decisions."

Investment companies

The association's examination program has been expanded to provide for more frequent and thorough inspections of investment company underwriters and retail distributors.

OTC clearing corporation

The association has been successful in organizing the National OTC Clearing Corp. This culminates 23 years of work. Operations began in August of this year with the corporation providing a clearance facility for transactions in over-the-counter securities in the New York metropolitan area with respect to 167 companies in a pilot program. It is anticipated that the program will eventually cover more than 1,300 over-the-counter stocks.

Disciplinary proceedings

The enforcement program of the association has been markedly stepped up. More disciplinary actions were initiated and decided in 1962 than during any other year. The association found 75 percent more violations of its rules and dismissed 20 percent fewer complaints than it did in 1961.

The association in 1962 also assessed stiffer penalties than during any other year. It expelled 27 percent more members and revoked the registrations of 61 percent more registered representatives than it did in 1961. Its suspension rate was also higher in 1962. Fifty percent more members and 220 percent more registered representatives were suspended than in 1961.

The association in July 1963 adopted a new policy for giving the public more information about disciplinary actions against members and their salesmen. Under the new policy, suspensions of both members and salesmen have been added to the categories of disciplinary actions receiving public announcement.

Qualification and entry standards

Effective January 1, 1962, the association introduced a new and stiffer qualification examination for registered representatives. And in November 1962 the score required to pass the examination was upgraded so that an average of one-third of all individuals currently taking the examination fail. Under the old examination and grading standards the failure rate for many years was under 1 percent. In conjunction with the new examination the association has prepared and published a study guide which can be used both in home study courses and as a basis for classroom programs.

The association has also recently adopted a written examination for member firm principals and officers who are new to the securities business. The examination is 4 hours' long and covers the Commission's recordkeeping, net capital, and hypothecation rules as well as its statement of policy on investment company matters. The association's rules on supervision of salesmen and its uniform practice code are also covered. As stated by officials of the association, the examination deals with "those fields of knowledge that must be understood by individuals in positions of authority, policymaking, and supervision in the securities business."

Underwriters' compensation

The association has acted to curb excessive compensation in underwriting arrangements. All offerings of unseasoned companies (whether interstate or intrastate) are not reviewed to determine whether the underwriting arrangements are "unfair" or "unreasonable."

Public complaints

The association's procedures for reviewing and investigating investor complaints have been improved. In early 1962 the important New York district for the first time assigned a staff employee to handle and investigate such complaints on a full-time basis. The association's district 11 (Pennsylvania, Delaware, West Virginia, and southern New Jersey) also has adopted procedures for more expeditious handling of investor complaints including a procedure for systematically following through on them.

Coordination of activities with the States and the exchanges

The association since late 1961 has been in the forefront in developing a single qualification examination which could be used by the States, the exchanges, and itself. Already the association in conjunction with the NYSE and Amex, has put into effect a joint testing program. In addition, as noted in the section on the NYSE, progress has been made with the NYSE and Amex to bring about coordination of certain of their other regulatory and enforcement activities.

THE REGIONAL EXCHANGES

The regional exchanges also have been active in effecting changes in existing policies and practices. While the listing below is not all inclusive, it nevertheless affords some idea of the current steps which certain of the regional exchanges have taken to improve their performance.

MIDWEST STOCK EXCHANGE

The exchange has improved and toughened its examination for registered representatives. It also has increased its enforcement activities. In 1962 alone it instituted more disciplinary proceedings than in the 5 previous years combined.

The exchange's examination program in 1962 also was stepped up. It expanded its own auditing staff and hired the public accounting firm of Arthur Young & Co. to help conduct member examinations. As a result of this added assistance the exchange made 93 examinations in 1962, an increase of 45 percent over 1961. In addition, member firms now are required to have one of their two annual financial questionnaires prepared by a certified public accountant on the basis of a surprise audit.

PACIFIC STOCK EXCHANGE

Exchange officials have indicated that the staff report on the American Stock Exchange focused their attention on the need for additional surveillance and enforcement activities. In this connection the following changes have already been put into effect.

To begin with, the exchange has adopted a new and more difficult qualification examination for registered representatives. Further, it now requires members to prepare their annual long-term financial questionnaire on a surprise audit basis. In addition to the financial questionnaire, all "PCSE only" firms are now also required to file a monthly computation of capital.

The exchange has also acted to improve the quality of its listings. Specifically, it has suggested to 14 of its listed companies whose securities have been selling below $1 that they consider a reverse split so that the unit price per share will be at least $1. And without setting an effective date for compliance, the exchange recently announced that PCSE "listed only" companies will be required to hold annual meetings, solicit proxies, and publish semiannual earnings reports.

The exchange has also tightened its policies in connection with trading in unlisted securities. It has announced that companies not listed on a national securities exchange would lose their unlisted trading privileges unless they became listed. The exchange wants to assure that all securities enjoying its trading privileges are meeting the stockholder reporting and other requirements of at least one national exchange.

Members of the exchange have recently voted in favor of a plan to improve the organization of the exchange and to eliminate differences in procedures between its two branches. The board of governors has stated that one of the plan's specific objectives is to "resolve a number of the recommendations of the Special Study * * * concerning Pacific Coast Stock Exchange operations."

INDIVIDUAL FIRMS

While no attempt will be made here to catalog all corrective measures introduced by individual firms over the course of the market study, nevertheless, certain of the more important ones merit consideration and are discussed below.

Selection, training, and supervision of personnel

Industry leaders seem to agree that major changes have been effected in this area. In this regard, in February 1962 the president of the New York Stock Exchange stated: "There probably never has been a time when so many firms throughout the securities industry were spending so much effort and money on the selection and training of personnel."

The president of the Investment Bankers Association in November 1962 similarly commented: "Investment banking firms are tightening their operations in large part because of the investigation of the securities markets by the Securities and Exchange Commission. This is particularly noticeable in the area of training and indoctrinating new salesmen, their supervision, and the establishment of controls."

Specifically, such firms as Bache, Reynolds & Co. and Hayden Stone all announced plans in early 1962 to expand and lengthen their new salesmen training programs. Some firms established programs for training their clerical and back-office employees.

The New York Stock Exchange during 1962 held conferences with member firms in order to assist them in formulating their training programs and to provide a forum for the exchange of ideas on training techniques.

General controls

In the area of general controls one firm, whose officers testified at the Special Study's public hearings in May 1962, shortly thereafter notified the staff of the study that it had formulated and sent to all of its branch managers and registered representatives a "detailed code of ethics" to guide them in their dealings with investors. This document bottomed on the precept that "customers' interests must come first" covers such matters as customer recommendations, adequate disclosure of material facts, and proper supervision of salesmen's activities and correspondence.

Responses to Special Study questionnaire IC–1 indicated that 8 of the 39 mutual funds receiving the questionnaire had adopted for the first time subsequent to the commencement of the Special Study a formal written policy restricting insider use of advisory and research information.

OTHER INDUSTRY GROUPS

Significant changes have also been effected by other industry organizations. It should be noted that unlike the exchanges and the NASD, the organizations considered here are not official self-regulatory bodies and thus are not within the Commission's direct regulatory sphere. It should also be noted that some members of certain of these organizations might have little or no contact with the securities industry. For such reasons, only those changes effected by these organizations which have clear application to the securities business are mentioned.

INVESTMENT COMPANY INSTITUTE (FORMERLY KNOWN AS THE NATIONAL ASSOCIATION OF INVESTMENT COMPANIES)

The Investment Company Institute, the spokesman for a substantial segment of the investment company industry, was reorganized in October 1961. In early 1962 the institute adopted a "Guide to Business Standards." The guide enunciates certain principles of fair dealing covering such matters as private dealings, disclosure of investment decisions and portfolio changes, the purchase of securities before dividend dates, effecting transactions in portfolio securities, selling practices, and income, dividend, and capital distributions.

THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

The association, spokesman for some 54 investment counseling firms, in late 1962 put into effect an accreditation program designed to raise the level of technical competence of those rendering investment counseling services. Individuals of member firms who successfully complete the program will be entitled to hold themselves out as a "qualified associate" of the association.

THE FINANCIAL ANALYSTS FEDERATION

This organization, a federation of 28 local analyst societies with some 7,775 individual members, adopted in May 1962 a "Code of Ethics and Standards" which spells out in general terms the analyst's responsibilities to the public, his clients, his employers, his associates, and his sources of information. The organization has recently put into effect a new testing program designed to raise standards of individual practitioners engaged as financial analysts. It is intended to confer upon those practitioners who complete the program the designation of "Charter Financial Analyst." When fully implemented the program will call for candidates to take a series of three 4-hour examinations, no more than one in any one year. In addition he will have to be at least 24 to take the first test, 26 for the second, and 30 for the third. And to be eligible for the final two examinations, the candidate will have to be a member of a security analyst society affiliated with the federation and have to have had "work experience of a responsible nature in financial analysis."

THE PUBLIC RELATIONS SOCIETY OF AMERICA

In chapter IX.C of the Special Study Report, it was suggested that many of the abuses in financial public relations practices could best be controlled by industry organizations. The Public Relations Society of America, acting on this suggestion, and working closely with the Commission's staff, has recently formulated standards for improving the general level of financial public relations. The society also has plans for an accreditation program designed to increase the proficiency and raise the ethical standards of those engaged in this work.

Mr. CARY. Because of the recent vintage of many of the developments, their full impact and adequacy cannot yet be determined. All appear to point in the right direction.

It should be emphasized that the agencies involved took the initiative in executing these changes. Some are evolutionary in nature and would have come about in time with or without the study. But the study undoubtedly accelerated the development and adoption of certain of these practices and rules. Others appear clearly attributable to the study, either resulting from its recommendations or its inquiries into specific areas, which suggested improvements to those examined.

Now, Mr. Chairman, I would like to move to the implementation of the Report of the Special Study, first relating myself to the principles of operation on which we have been proceeding.

I shall now discuss our approach to implementation of the study report. There are certain principles we are following. First, then it is necessary and essential to secure the views of the financial community before taking final action. Such a policy is required by law in our rulemaking activities. An interchange of idea with the affected parties, even if it were not so required, is necessary to an effective program. The study itself did not have the benefit of industry views on its recommendations. On the other hand, the Commission should not act without them but, of course, is not bound by them. We have sought and are seeking industry reaction on the necessity and feasibility of the proposals and we will explore alternative recommendations—where appropriate—to the problems presented. We do not have the illusion that every rule can be arrived at with unanimity. At the same time, we do have the conviction that discussions with the industry and the self-regulatory bodies make for fair, reasonable, and responsible solutions. This procedure was followed in our legislative program; and we have presented to the Congress a very important bill with practically unanimous industry support.

Second, we appreciate, as the study report carefully pointed out, that the issues presented are subtle and complex; many are just emerging and many call for further study. Some subjects, such as automation, are long range in nature, far reaching in impact, and require a continuing and more elaborate analysis of a development still in its infancy. In a similar vein, any proposals regarding the structure of the New York Stock Exchange commission rate schedule must be premised upon a thorough understanding of the effects any change in that structure would have on other sections of the securities markets, such as the regional exchanges. Another group of subjects requiring further exploration are those we have so designated in our letters to Chairman Harris. These are not being neglected and further, necessary examination is now going on.

Third, the study report has presented us with a large undertaking. There are 175 recommendations and numbers tell only part of a story because of the complexities associated with many of them. This means, quite frankly, we shall not complete our job in 6 months or 1 year. On the other hand, we are moving with dispatch and we believe the industry appreciates our emphasis upon prompt and effective action. Much has been achieved already and matters are proceeding in an orderly fashion.

As my previous discussion has underscored, the industry itself, from the beginning of the study, has been making changes, many of which anticipated the study's recommendations. Thus, in a real and important sense, implementation has been going on well in advance of the issuance of the final segment of the report in August. The more formal program arising out of the study report can perhaps be divided into two parts: (1) Rulemaking by the Commission and by the self-regulatory agencies, and (2) our legislative program as embodied in H.R. 6789.

B. RULEMAKING

Most of the problems revealed by the report of the Special Study can be handled under the rulemaking authority of the Commission or the self-regulatory agencies. Accordingly a major part of our present efforts, and that of the agencies, has been devoted to an examination of the need for new rules or strengthening the enforcement of existing ones.

(1) Office of Program Planning: The Commission has taken active measures to organize its personnel for the implementation program. As a first step, in July of this year, we established a new Office of Program Planning. That is headed by Mr. Walter Werner, sitting right behind me. This was in accordance with the report's recommendation for the creation of a group within the staff to concentrate on the analysis of long-term trends and needs in the regulation of the securities markets. The immediate responsibility of the new office has been to assist in coordinating and implementing the report's recommendations. Much of the implementation activity is being performed, of course, by regular operating divisions and offices of the Commission's staff.

I am pleased to report that we have been able to retain many of the Special Study personnel on the Commission's staff against a barrage of competitive inducements. They are generally engaged in important

aspects of the implementation program so that we will continue to have the benefit of their intimate knowledge of the problems which gave rise to the study's recommendations.

I will next go into the establishment of priorities.

(2) Establishment of priorities: The great number of recommendations contained in the Study Report made it necessary to establish a schedule of priorities. To this end, the recommendations have been divided into two main groups. The first, those of particular concern to specific self-regulatory agencies, have been taken up with the affected exchange or the NASD and agreement has been reached on the subjects to be given first attention. Thus, in the exchange area, priority designation has been given to the proposals relating to odd-lot dealers, floor traders, specialists, and automation. Further, the Commission and the NASD are giving first priority in the over-the-counter market to the quotation systems, the "markup policy," execution of retail transactions and the strengthening of the organization and structure of the NASD itself.

The other major factor or group of recommendations are those of concern to the securities industry as a whole, transcending the particular interest of any one self-regulatory agency. These have already been discussed with the members of the Industry Advisory Committee, the same committee which we consulted in the preparation of H.R. 6789. The committee which is designating appropriate subcommittees to consider such vital matters as selling practices, the establishment of minimum capital requirements, and rules relating to the conduct of those who distribute securities.

We have included those matters in the priority groups which in our opinion warrant immediate attention. As a practical matter we cannot implement all 175 specific recommendations immediately and simultaneously. But those recommendations not receiving first priority are being neither discarded nor neglected. A considerable amount of work has already been done on a number of them; it is our expectation that in a reasonable period of time they will all receive full attention and action by the Commission and its staff.

Mr. HARRIS. Do you have, Mr. Cary, any statement which of the 175 specific recommendations you have considered and have taken action on? Has that been separated from those that you have not considered yet?

Mr. CARY. I would not say that perhaps we have analyzed it in that way, because we have actually taken no steps which are in the nature of rulemaking proceedings except one, and that was issued today, as a matter of actual fact.

That was a rule proposal which relates specifically to the point that material contained in the financial statements of annual reports must be consistent with financial material filed with the Commission. By and large, Mr. Chairman, these big issues which we have taken up and to which we have given priority are in the negotiations and discussions stage with the industry.

Mr. HARRIS. What are those big issues? Minimum capital requirements, rules relating to the conduct of those who distribute securities and selling practices? Are those the ones you call the big issues?

Mr. CARY. Those are the big issues. On page 24, the big issues we felt to be, in relating ourselves to the exchanges first of all, were mat-

ters dealing with odd-lot dealers, floor traders, specialists, and automation.

With respect to the NASD we are concentrating primarily at the moment on quotation systems, the markup policy, execution of retail transactions, and the strengthening of the organization of the NASD itself.

When we come to the areas that involve the industry as a whole, we are concentrating or selling practices, the establishment of minimum capital requirements and rules relating to the conduct of those distributing securities.

Now I would like to go on to Commission policy in regard to the self-regulatory agencies.

(3) Commission policy in regard to the self-regulatory agencies: As you can readily see from my comments here today, we expect the self-regulatory agencies to carry a large part of the responsibility of providing investor protection. This reliance means that these agencies must advance in many respects in order to attain a high level of perforance in all of their functions. It also means that the Commission must fully exercise its powers of oversight and supervision.

To that end, the Division of Trading and Exchanges, renamed the Division of Trading and Markets, has been reorganized and strengthened so that it can more adequately oversee the operation of the self-regulatory agencies, examine on a continuous basis changing market circumstances and regulatory needs, and appraise the adequacy of existing regulatory measures. An Office of Regulation has been established within the division to carry out these responsibilities. An existing Office of Statistical Studies within the division has been expanded to provide for the compilation of more comprehensive data relating to the trading markets.

In addition to changes in organization, important oversight programs have been strengthened or instituted by the Commission. A plan for more thorough and more regular inspections of the exchanges has been approved by the Commission and inspections by the staff pursuant to this plan will soon commence. These will concentrate on the problem areas discussed in chapter XII of the Special Study Report. The program is intended to be flexible and, if it becomes evident that more or less attention should be paid to particular areas, adjustments will be made.

To provide for a more thorough and orderly review of exchange rules and policies, as recommended by the Special Study Report, the Commission is now discussing procedures with the exchanges to secure reports of proposed exchange rules. This will permit the Commission to offer its comments on a rule prior to formal adoption or effectiveness. With regard to exchange disciplinary proceedings, the Commission and the New York Stock Exchange are examining the necessity for further procedural safeguards for those affected by exchange actions—an examination dictated in part by the decision of the Supreme Court in *Silver* v. *New York Stock Exchange*. The New York Stock Exchange has recently provided for appeals to the Board of Governors in the case of disciplinary proceedings against registered representatives. We are continuing to consider and explore with the exchange other problems presented by the *Silver* case, including analysis of the need for some form of review by the Commission of exchange disciplinary actions.

Resolution of many of the regulatory and oversight problems in the over-the-counter markets depends ultimately upon strengthening of the NASD. Meanwhile, programs have been instituted to obtain from the NASD the full records of disciplinary proceedings in selected cases and to establish recordkeeping and statistical systems for evaluating and analyzing disciplinary cases. Plans have been formulated, moreover, to obtain more detailed periodic reports from the NASD with respect to its examination program (i.e., member inspection) and to secure for the first time data on the informal dispositions of the disciplinary matters (for example, letters of caution). These will be supplemented by a program for inspecting NASD district offices on an annual basis, as well as by stepping up our present program of conferences with the national office staff officials.

With the possible exception of problems raised by the *Silver* case, at this time we do not believe that the present statutory pattern requires amendment—aside from that recommended in H.R. 6789—in order to achieve more effective and more pervasive self-regulation. Refinement of our own practices, as we have commenced doing, should attain the desired results. For example, in the exchange area, reports of newly proposed rules will enable us to be aware, on a continuing basis, of developments in an exchange's policies and to determine the rule's consistency with the Exchange Act. As another example, although our authority to alter or amend the rules of the NASD is more limited than in the case of the exchanges, we can utilize our direct powers over practices in the over-the-counter market, in many respects unexercised. Until these have been fully exercised and found wanting, we do not see any need to ask the Congress for legislation. In any event, up to this time needed improvements have been secured after conferences and discussions with the NASD.

With regard to the self-regulatory agencies' responsibilities in the implementation program, we view our duty as seeing that these agencies act with reasonable dispatch and in a reasonable manner to meet the problems disclosed by the report. We have kept in close contact with the major exchanges and the NASD to keep informed of their progress; in addition to the steps already taken, the New York Stock Exchange has engaged consultants to make studies in the key areas for floor trading, odd lots and specialists. General target dates have been set for those studies and the exchange's own analysis. Committees of the members have been formed to analyze the various problems affecting the exchange which were raised by the study. Meanwhile our staff has been meeting in exploratory conferences with the staff of the exchange on the report and its recommendations. Our staff has also been conferring with representatives of the American Stock Exchange, which has programs proceeding in many areas, including specialists and automation. Conferences have been held with the NASD, which has organized committee to examine the very important problems of retail quotations, markups and organization.

(4) Selling practices; distributions; minimum capital: The staff has examined the report and isolated out those matters of primary concern to the Commission as distinguished from the self-regulatory agencies. These generally relate to the industry as a whole. For example, in the area of selling practices, the report recommends that the Commission adopt rules to facilitate and reinforce controls by

firms, self-regulatory bodies and the Commission. At the present time, the staff is analyzing the study's recommendations and exploring means of meeting the problems disclosed. The staff is also analyzing the important question of appropriate controls over selling literature. Here the New York Stock Exchange has already strengthened its rule and the NASD is in the process of rewriting its requirements. Accordingly, a threshold question is the need for Commission action.

The report recommended a minimum capital requirement for brokerage firms and for underwriters. H.R. 6789 would expressly permit the NASD to establish standards of financial responsibility. Without in any way derogating from the standards that might be established by the NASD, our staff is studying the need for a Commission rule in this area as well.

In chapter IV of the report the study criticized present controls over new issues. Certain of its criticisms have been taken care of in H.R. 6789. In the area of "hot issues" we are still exploring some of the study's proposals and the staff is consulting with various representatives of the securities industry. The staff is also reexamining our basic antimanipulative rule, rule 10b–6, which the study said needed further clarification.

(5) Administration of disclosure requirements: The study report contains several recommendations relating to our administration of the disclosure requirements of the securities acts. Certain of these would be taken care of by H.R. 6789; others are under active consideration. For example, a rule proposal has been prepared, based on a study recommendation, which would require that financial statements sent to shareholders by companies subject to the proxy rules not be materially misleading in light of those filed with the Commission. May I say that is the one that was issued yesterday and which appeared in the paper today?

Mr. HARRIS. What do you mean by materially misleading here? Does that mean it can be misleading just a little bit?

Mr. CARY. Well, sir, that is a very common phrase. It is used in the securities acts. We don't say that it can be misleading a little bit. But what we say is that when literature is subject to some kind of liability, Mr. Chairman, the securities industry would, I think, be the first to say that the literature should be materially misleading in order to generate liability. I think that is the reason why "materially misleading" is a familiar phrase in several parts of the securities acts.

Mr. HARRIS. It is a little bit misleading.

Mr. CARY. It may well be. It has come to be a tradition in these laws.

Moreover, the staff is engaged in a thorough reexamination of regulation A to determine what amendments are necessary in view of the findings of the report and the Commission's experience. Furthermore, we have talked with the principal investment advisory services and others in an effort to develop procedures which would result in the wider dissemination of information filed with us, as suggested by the report.

In other words, we want to make sure that information gets into the investment advisory services, which is the thing that the public consults all over the country.

Independently of the Study Report, we have recently commenced a review of our overall program in the disclosure field. Through this process, we are hopeful of improving our disclosure standards, where necessary, and of making our operations more responsive and comprehensible to those who deal with us. In the former category, our proxy rules are presently undergoing thorough analysis, reanalysis.

In the latter, we anticipate publishing a series of releases designed to clarify Commission policies in a number of areas.

I have, as you know, spent the morning relating my discussion to H.R. 6789, and that implements several of the most important recommendations of the study report. I should, if I may, like to offer for the record at this time a detailed list of the particular study recommendations, about 30 in number, reflected in the bill which we have submitted this morning.

I would like to submit that as an addition to the record. It is entitled "Recommendations of the Special Study of Securities Markets That Would Be Implemented by the Bill," and it is dated November 19th, Mr. Chairman.

Mr. HARRIS. I have been looking for a copy of that. I have located it.

Mr. STAGGERS. Without objection, that may be done.

(The recommendations referred to follow:)

RECOMMENDATIONS OF THE SPECIAL STUDY OF SECURITIES MARKETS THAT WOULD BE IMPLEMENTED BY THE BILL

The three virtually identical bills now pending before the Interstate and Foreign Commerce Committee of the House of Representatives, H.R. 6789, H.R. 6793, and S. 1642 (for convenience hereinafter collectively referred to as the bill) would implement several of the most important recommendations of the study. Indeed, most of the provisions of the bill are based upon and supported by the study.

The bill for purposes of discussion can be divided into two parts, one relating to increased disclosure and other investor protections and the other to improved qualifications of, and controls over, those in the securities business—broker-dealers and their principals, supervisory personnel, salesmen, and other personnel. This memorandum briefly summarizes the study recommendations in each of these major areas that would be implemented by the bill. In some cases, the implementation by the bill of the study recommendation mentioned would be complete and in other cases only partial. In some instances, a portion of the bill, although based on the study, reflects some modification of the underlying study recommendation.

In total, the bill would implement (in whole or in part) or directly aid the implementation of 33 recommendations of the study.

INCREASED DISCLOSURE AND OTHER INVESTOR PROTECTIONS

The study recommended (rec. 1, ch. IX.B) that the reporting, proxy, and insider trading protections of, respectively, sections 13, 14, and 16 of the Exchange Act be extended to widely held over-the-counter companies. Sections 3(c), 3(d), 3(e), 4, 5, and 8 of the bill would do that.

The study recommended (rec. 6, ch. IX.B) that any over-the-counter company that wishes voluntarily to register and comply with sections 12, 13, 14, and 16 of the Exchange Act be allowed to do so. Section 3(c) of the bill so provides.

The study stated (rec. 2, ch. IX.B) that section 15(d) of the Exchange Act, which requires certain companies making a public offering of their securities to comply with section 13 of the Exchange Act and make periodic public reports to the Commission, should be changed to eliminate the cumbersome undertaking requirement now contained in that section and to make that section applicable to every issuer making a public offering and thereafter having 300 or more security holders. Section 6(d) of the bill would implement that recommendation.

The study recommended (rec. 4, ch. IV.B) that section 4(1) of the Securities

Act of 1933 be amended to provide that in the case of a public offering of securities by an issuer who has not theretofore sold a security to the public under a registration statement, the applicable period after the effective date of a registration statement during which dealers must use prospectuses in selling such a security be extended to 90 days from the presently applicable 40 days. The study, in that recommendation and in recommendation 3 of chapter IV.F, also stated that the Commission should be given flexibility to shorten either the 40- or the 90-day requirement in appropriate situations. Section 11 of the bill would implement these recommendations.

The study recommended (rec. 1, ch. IV.F) that there be increased coordination between the filing requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 and that a company which is subject to sections 13, 14, and 16 of the Exchange Act should, with such exceptions as might be appropriate, be subject to less stringent requirements upon a public offering under the Securities Act, because a reservoir of information about such a company will be available under the Exchange Act. Section 11 of the bill, discussed immediately above, would provide the Commission with more flexibility on prospectus-delivery requirements, which would aid the Commission in a program of increased coordination.

The study recommended (rec. 3, ch. IX.B) that section 12(f)(3) of the Exchange Act be deleted so that the only securities having unlisted trading privileges on an exchange without being listed on any exchange would be those having such privileges at this date. This change is contained in section 3(b) of the bill.

Recommendation 7(b) of chapter IX.B of the study is that section 14(b) of the Exchange Act be amended to empower the Commission both to compel the giving and to control the manner of giving of proxies on customers' securities, both listed and unlisted, held by broker-dealers. Section 5(b) of the bill so provides.

The study recommended (rec. 2, ch. IV.F) that, apart from specific changes such as the change in section 14(b) of the Exchange Act (discussed above), the existing proxy solicitation requirements should be reviewed by the Commission and any deficiencies appropriately corrected. Under existing law, a company that would be subject to the proxy requirements and that would therefore have to furnish security holders with appropriate information (including an annual report if directors are to be elected) if it were to solicit proxies in respect of a meeting can avoid this requirement by simply not soliciting. Section 5(c) of the bill would correct that deficiency by adding a new section 14(c) to the Exchange Act. That section would require an issuer which would be obligated to send a proxy statement and other information if it were to solicit proxies to send equivalent information to security holders when it does not solicit proxies in respect of a meeting.

IMPROVED QUALIFICATIONS OF, AND CONTROLS OVER, THOSE IN THE SECURITIES BUSINESS

The study recommended (rec. 1, ch. II) that all broker-dealers should be required to be members of a self-regulatory body. The study also specifically recommended (rec. 1, ch. IV.E) that broker-dealers selling real estate securities should be required to be members of a registered securities association. Section 6(a) of the bill would implement these recommendations.

The study recommended (rec. 7, ch. III.B) that the Commission be given the right to impose sanctions lesser than revocation of registration in disciplinary proceedings against broker-dealers. Section 6(b) of the bill would give the Commission these powers. Under that section, where a broker-dealer firm is involved in a disciplinary proceeding the Commission would have the power (in lieu of revocation of registration) to censure, or suspend for up to 12 months the registration of, the firm if it or any person associated with it is found guilty of misconduct specified in the statute.

The study recommended (rec. 5, ch. II) that the Commission should have the power, as an alternative, to proceed directly against and discipline individuals associated with a broker-dealer without joining the broker-dealer. Section 6(b) of the bill would authorize such a procedure where an individual is alleged to have been guilty of misconduct specified in the statute.

The study recommended (rec. 2, ch. II) that the list of offenses that permit the Commission, if it finds it in the public interest to do so, to deny or revoke registration as a broker-dealer be expanded to include a broader range of specified finan-

cial offenses, all of which reflect upon a person's suitability to deal with the public in a position of trust. Section 6(b) of the bill would do this by expanding that list to parallel closely the list most recently approved by Congress in a Federal securities statute—the list contained in the Investment Advisers Act, as amended in 1960.

Recommendations 6 through 12 of chapter II of the study relate to increased qualification standards (character, competence, and capital) for principals and employees of broker-dealer firms. Section 7(a)(3) of the bill would make the authority of registered securities associations in these areas more explicit and would authorize and direct such associations to adopt improved standards.

The study recommended (rec. 1, ch. III.B) that the supervision by broker-dealers of the selling activities of their personnel, particularly in branch offices, should be generally strengthened. Section 6(b) of the bill gives proper supervision more emphasis on the face of the statute, for that section of the bill would expressly provide that a supervisor failing properly to supervise a person who is under his supervision and who commits a disqualifying act may be barred from registration as a broker-dealer or from being a person associated with a broker-dealer, if the Commission finds it in the public interest to do so.

Ten of the study's recommendations in chapter VII relate to quotations of over-the-counter securities. Section 7(a)(6) of the bill would expressly authorize and direct registered securities associations to have rules in this area.

The study recommended (rec. 1, ch. XII.J) that there be increased cooperation and coordination between the various self-regulatory bodies. Section 7(a)(1) of the bill is a step in this direction. That section of the bill would allow a registered securities association to adopt rules, subject to Commission approval, which would permit exclusion from its membership of persons who have been suspended or expelled from an exchange for violation of any of the exchange's rules. It is anticipated that only serious misconduct of a nature affecting the protection of investors would be grounds for exclusion, and any such action would be subject to Commission review. This action would resolve a problem existing primarily between the NASD and the New York Stock Exchange with respect to the collateral effects of the latter's disciplinary proceedings.

Mr. CARY. In its analysis of shortcomings, the report placed great emphasis on two points, the need for higher standards of qualification for persons in the securities industry; and (2) the need for more reliable and complete disclosure by companies traded in the over-the-counter market.

Going on, then, I will proceed to other legislative proposals of the report.

We have not incorporated all of the study's legislative recommendations in our program. There are various reasons for this. We have already spoken to the question of Commission oversight over the self-regulatory agencies. In the area of security credit regulation, the primary responsibility is with the Federal Reserve Board. We have indicated our intention to work closely with the Board toward the resolution of any problems raised. As to controls over quotations of over-the-counter securities, we are considering a statute providing for the registration of publishers of these quotations unless additional examination indicates that the revealed inadequacies can be met through further regulation of brokers and dealers.

The study also recommended that investment advisers be required to be members of a self-regulatory agency, and we have been meeting with industry representatives to determine the most feasible way of achieving this result. Finally, as to the protection of customers' funds and securities, part of the problem must be met through amendments to the bankruptcy laws.

At this juncture, we cannot say whether there will be further legislative proposals arising from the study. Clearly there will be none this year. To the extent that further analysis indicates that there

are problems that cannot be solved under our present powers or those of the self-regulatory agencies, we shall certainly make appropriate legislative proposals to the Congress.

Finally, Mr. Chairman, I would like to make a brief reference to mutual funds.

Any discussion of the study report would be incomplete without reference to mutual funds. By way of background, as the subcommittee is aware, on August 27, 1962, the Commission transmitted to the Congress "A Study of Mutual Funds," representing a factfinding survey of certain aspects and practices of open-end investment companies. This study was prepared by the Wharton School of Finance and Commerce.

At approximately the same time, the Commission requested its Division of Corporate Regulation to undertake a detailed analysis of the Wharton School study and conduct a thorough study of various mutual fund complexes in order to more fully understand the structural problems of the industry. The examination is scheduled to be submitted to the Commission in the near future.

The Commission has not received any of the division's recommendations and so we obviously are not in a position to comment on possible proposals. After we have reviewed them, it is anticipated that conferences will be held with industry representatives respecting those areas where the Commission ascertains a need for action.

Meanwhile, chapter XI of the study report, dealing with selected aspects of mutual funds, represents an important contribution to the overall picture. That chapter covered selling practices, insider trading in portfolio securities, reciprocal business patterns, and contractual plans. The former topics are under consideration. The reciprocal business question is tied in with our review of the New York Stock Exchange minimum commission rate schedule and is also being analyzed in the staff study.

The Special Study report raised serious questions about contractual plans, which involve the purchase of mutual funds on an installment basis, with a substantial portion of the first year's payments—generally 50 percent—taken out for sales load. The questions raised by the study revolve basically around the size of the initial load. The Commission has not arrived at any conclusions with respect to the study report's recommendations on contractual plans.. We are now awaiting a presentation by the Association of Mutual Fund Plan Sponsors, a trade association representing the major sellers of contractual plans. In a sense, it is a response to the chapter XI analysis that was made available. No judgments will be reached until we have completed our analysis of the sponsors' evidence.

Upon completion of our review of the staff study, we shall be in a responsible position to inform the Congress whether any amendments are required to the Investment Company Act of 1940. We shall also have a sound basis for major rule changes, where necessary.

In summary, the Commission believes that the report of the Special Study of Securities Markets has made a most vital contribution to investor protection. As a result of the study, highly significant improvements in standards throughout the securities markets have already occurred. Enactment of H.R. 6789 will be another notable advance. The Commission and the financial community are now

actively engaged in further implementing other recommendations of the report. This process is proceeding with diligence and thoroughness and will continue in this vein.

Mr. Chairman, that completes my reading of these statements.

Mr. STAGGERS. Mr. Chairman, I want to thank you for your statement on the work of the Special Study Group and on the Commission's recommendations for action arising from that study. I think it is a very fine one, very comprehensive, and I think it is well that it was read at this public hearing.

I would like to ask just two brief questions.

Mr. HARRIS. Mr. Chairman, before you do that, could I inquire on a point concerning the record? I notice that each of us has a statement, a rather voluminous statement, which contains 78 pages, together with attachments. This is dated November 19, "Statement of the Securities and Exchange Commission With Respect to Proposed Amendments to Sections 12, 13, 14, 15(c)," and so on and so forth.

What is this statement in relation to the two statements you have already presented, and one or two that we have had included in the record?

Mr. CARY. Mr. Chairman, this is a further justification of the bill itself.

Mr. HARRIS. Is this a repetition in another way of what you have already given in your statement?

Mr. CARY. It is a supplementation, rather than a duplication, and further justification. I would like to have it made a part of the record, and if I have failed to ask that it be made part of the record, I would like to request it to be made.

Mr. HARRIS. If it is a supplement, I would agree that it should be part of the record.

Mr. CARY. I assure you it is not just a regurgitation. It has additional materials.

Mr. STAGGERS. Without objection, it may be placed in the record.

(The document referred to follows:)

STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION WITH RESPECT TO PROPOSED AMENDMENTS TO SECTIONS 12, 13, 14, 15(c), 15(d), 16, 20(c), AND 32(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 4(1) OF THE SECURITIES ACT OF 1933

The most important effect of these provisions of the bill[1] would be to amend the Securities Exchange Act of 1934 to extend to investors in widely held over-the-counter companies the registration, reporting, proxy, and insider trading protections that investors in companies with a security listed on a national securities exchange now have under that act. This recommended extension is squarely supported by the findings and recommendations of the Special Study of Securities Markets.

These investor protections would initially be extended to companies having both a class or classes of equity securities held by 750 or more holders of record and over $1 million total assets. After July 1, 1966, or such later date as the Commission might select, the equity-security holders requirement would be re-

[1] S. 1642 as introduced was identical to the other two bills. Editorial, technical, and a few substantive changes were made by the Committee on Banking and Currency of the U.S. Senate. The only substantive change of major significance made by that committee was in connection with the proposed new sec. 12(i) of the Securities Exchange Act, dealing with the administration of the disclosure, proxy, and insider trading provisions of that act with respect to securities issued by banks. All of the substantive differences between S. 1642 and the other two bills are pointed out in the technical statement. References herein to "the bill" refer to each of the three bills, unless otherwise specifically noted.

duced to 500. (The term "equity security" is defined in section 3(a)(11) of the Exchange Act and includes capital stock and convertible debt instruments, but does not include nonconvertible debt instruments with no warrants or rights attached.) Under the 500 equity-security holders test, an estimated 3,900 companies would be covered, of which 1,700 presently file periodic reports with the Commission under existing section 15(d) of the Securities Exchange Act. These criteria would limit coverage to companies which are widely held and in which there is significant trading interest. The findings of the Special Study indicate that in 1961, 77 percent of the companies that would be covered by the bill had 200 or more record transfers of their stock and that two or more broker-dealers expressed an interest in the securities of 74 percent of those companies.

The investor protections that would be extended to these over-the-counter companies are—

1. Section 12 of the Exchange Act, which requires registration and filing of pertinent data (similar to that required under the Securities Act of 1933 upon a public offering of securities) with the Commission.

2. Section 13 of the Exchange Act, which requires the filing with the Commission by issuers of current financial statements and periodic reports concerning major corporate events. This information keeps reasonably current the information contained in the registration statement.

3. Section 14 of the Exchange Act, under which the Commission has adopted rules that insure that security holders are adequate informed and otherwise given an opportunity to exercise their corporate franchise when asked to give a proxy.

4. Section 16 of the Exchange Act, which combats misuse of confidential information by insiders of a corporation in their trading in its equity securities by (a) requiring corporate insiders to report their holdings of and transactions in the corporation's equity securities; (b) allowing recovery by or on behalf of the corporation of "short swing" profits by insiders in the corporation's equity securities; and (c) prohibiting short sales and "sales against the box" by the insiders.

None of these provisions of the Exchange Act is presently applicable to over-the-counter companies,[2] except that companies that have issued securities to the public under a Securities Act of 1933 registration statement are, under section 15(d) of the Exchange Act, subject to the periodic reporting requirements of section 13 of the Exchange Act if the value of the securities offered plus the value of all other outstanding securities of the same class amounts to $2 million or more. However, companies subject to section 15(d) of the Exchange Act, unlike exchange-listed companies, are not subject to the proxy rules of section 14 of the Exchange Act or the insider trading provisions of section 16 of the Exchange Act.

The disclosure provisions of the Exchange Act are based upon the premise that shareholders and investors are protected and the securities markets are sounder and function best when issuers whose securities are traded in these markets furnish information that is adequate for shareholders and investors to make informed investment decisions. Without adequate disclosures, shareholders and investors must make investment decisions in darkness, for a security's worth is peculiarly dependent upon the underlying assets, liabilities, operating results, and personnel of the issuer. The same premise underlies the Securities Act of 1933, which requires appropriate disclosure by an issuer which makes a public distribution of its securities.

Since 1934 the investor protections of sections 12, 13, 14, and 16 of the Securities Exchange Act have been applicable to corporations with a security listed on a national securities exchange. The approximately 2,400 companies with one or more securities listed on a national securities exchange have, with a few exceptions, had little trouble in complying with these provisions; and the benefits of increased shareholder protection and resulting investor confidence have made the exchange markets stronger, sounder, and more prosperous.

There is no rational reason why the present double standard for exchange-listed companies and over-the-counter companies should continue. Shareholders and investors in widely held over-the-counter companies deserve these protections as much as do shareholders and investors in exchange-listed companies. Moreover, the fast-growing and important over-the-counter market deserves the

[2] Investment companies registered under the Investment Company Act of 1940, and public utility holding companies registered under the Public Utility Holding Company Act of 1935 are subject to the same or similar requirements.

same benefits of increased investor confidence as exchange markets now have. Over-the-counter sales of corporate stocks, excluding mutual fund sales and syndicated distributions, increased almost 700 percent in 12 years—from an estimated $4.9 billion in 1949 to $38.9 billion in 1961. The volume of over-the-counter stock transactions in 1961, considering only public sales, amounted to approximately 75 percent of exchange transactions in terms of shares and 35 percent in terms of dollars.

The study has demonstrated that the investor protections of sections 12, 13, 14, and 16 are needed in the over-the-counter markets, and has demonstrated in detail how the existing disclosure and proxy practices of over-the-counter issuers do not measure up to the standards of exchange-listed companies. The securities industry and other important groups such as the Chamber of Commerce of the United States agree that these protections are needed. In fact, in the Senate hearings on S. 1642, there was no general opposition to the extension of these provisions to widely held over-the-counter companies, the only major opposition being to coverage of companies in certain fields.

Any burdens of compliance with the bill are minimal when compared to the benefits of adequate disclosure provided by the bill in these cases. The American Stock Exchange, on the basis of a survey of securities lawyers and accountants, has concluded that "the total cost of annual compliance with all of the requirements now applicable to listed companies apparently would be in the area of $1,500 to $3,000 for the smaller industrial companies covered by this bill except in most unusual circumstances." (Hearings before a subcommittee of the Committee on Banking and Currency of the U.S. Senate on S. 1642, 88th Cong., 1st sess., p. 153 (1963).)

Furthermore, Mr. James E. Day, president of the Midwest Stock Exchange, has estimated, on the basis of a similar survey of securities lawyers and accountants in the Chicago area, that the cost to smaller and medium size over-the-counter companies to meet the requirements of the bill should not be more than $1,500 to $2,000 except in the most unusual cases, and further concluded that for many of such companies which are now using legal counsel for tax purposes and receiving CPA audits, the cost may be as low as $500 more than they are now paying (Hearings before a subcommittee of the Committee on Banking and Currency of the U.S. Senate on S. 1642, 88th Cong., 1st sess., pp. 162–63 (1963)).

The above figures are for a covered company not now subject to the periodic reporting requirements of section 13 of the Exchange Act by virtue of section 15(d) of that act. Of the approximately 3,900 companies[3] covered by the bill, about 1,700 are subject to sections 15(d) and 13. The costs of compliance for the 1,700 section 15(d) companies would be considerably less than for covered companies generally since they are already complying with the reporting requirements of section 13.

None of these provisions of the bill regulates the business of a corporation, and none impinges upon the jurisdiction of the States, for section 28(a) of the Exchange Act provides that no provision thereof shall "affect the jurisdiction of the Securities Commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions [of the Exchange Act] or the rules or regulations thereunder."

The need for these provisions of the bill is discussed in detail below, and a summary of these provisions follows that discussion.

1. Disclosure philosophy of the Federal securities laws

The Federal securities laws are based upon the principle that the public interest is furthered and investors are protected from securities frauds when they are provided with adequate financial and other information to permit informed investment decisions about the securities in which they might invest, or have invested. This is reflected in the preamble of the Securities Act of 1933, which recites the purpose of that act to be to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

The Securities Act of 1933 made this principle applicable to securities initially offered for public sale, and the history of the Securities Exchange Act of 1934 shows that it was considered equally applicable to securities traded in the securities markets. Thus, the House Committee on Interstate and Foreign Com-

[3] These figures are based on the comprehensive survey conducted by the study, which survey is discussed in more detail below.

merce, in its report accompanying the Securities Exchange Act of 1934, stated:

"No investor; no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of powerful groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges. Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet." (House of Representatives Rept. No. 1383, 73d Cong., 2d sess. (1934) 11–12.)

The need for accurate information as a basis for investment decisions and as a bulwark against fraud and manipulation has been recognized not only by the Congress, but by leaders of the financial and business community. As the author of a recent study sponsored by the Financial Analysts Federation stated:

"We believe that no responsible management wants to have among its shareholders those who have paid too much for the stock of their company due to inadequate or poorly timed information.

"Unfounded rumors grow better in darkness than in the light of facts. The policy of providing complete information at the usual periodic reporting times has the definite advantage of precluding great 'surprises' to the shareholders and, perhaps more importantly, it lessens the likelihood of excessive overvaluation or undervaluation of the company's common stock in the marketplace." Anderson, Corporate Reporting for the Professional Investor (1962).

2. Disclosure requirements in the exchange markets

A comprehensive scheme of disclosure requirements now exists under the Securities Exchange Act of 1934 in respect of securities traded on national securities exchanges. Information concerning issuers, their securities and their officers, directors, and controlling shareholders must be furnished under the registration and reporting requirements of sections 12 and 13, and the proxy and insider trading provisions of sections 14 and 16.

As a prerequisite to the listing and registration of a security on a national securities exchange, section 12 of the Exchange Act requires that the issuer of the security file an application for registration with both the exchange and the Commission. The application must contain financial information and other material essential to a determination by an investor of the merits of the security. This includes such relevant information and documents in such detail as the Commission may require as to the issuer's business; its outstanding securities; the identity and the remuneration of officers, directors, and principal shareholders; their interests in the securities of, and their material contracts and interests in transactions with, the issuer; bonus and profit-sharing arrangements; management and service contracts; options which are existing or are to be created with respect to the issuer's securities; and balance sheets and profit-and-loss statements, certified by independent public accountants if so required by the Commission's rules and regulations.

Section 13 of the Exchange Act requires the issuer of a security registered on a national securities exchange to keep reasonably current the information contained in the application for registration and to file annual and other periodic

reports. Regulations of the Commission adopted under section 13 currently provide, with some exceptions, for the filing of annual reports containing certified financial statements, semiannual reports of uncertified profit-and-loss and earned surplus statements, and current reports whenever important events of immediate interest to investors occur. In addition, certain real estate companies must file quarterly statements of profit and loss, sources of funds, and cash distributions to shareholders.

With the exception of information accorded confidential treatment, all materials filed pursuant to sections 12 and 13 are available for inspection by the public, and copies can be obtained from the Commission upon payment of reproduction fees.

Section 14 governs the solicitation of proxies relating to securities listed and registered on a national securities exchange. The purpose of the section and the Commission rules thereunder is to provide shareholders with an opportunity to exercise their corporate franchise on the basis of accurate and adequate information. Proxy statements must include information about the persons on whose behalf proxies are solicited, nominees for directorships, and any other matters to be voted on. Thus, if the management of a listed company solicits proxies, the proxy statement sent to shareholders must contain information on such matters as management compensation—including bonuses, pension, and profit-sharing plans—loans to directors and officers, and other material transactions between the corporation and its officers, directors, and principal shareholders. If the shareholders are asked to vote on a merger or other corporate change, they must be given an opportunity to vote for or against the proposal and may not be put to the option of either voting as the management proxy indicates, attending the meeting—which may be many miles away—or forfeiting their votes. Under certain conditions a shareholder may also require the management to place in the proxy statement proposals of his own for action at the meeting along with a brief supporting statement. If the proxy statement relates to a meeting at which directors are to be elected, the shareholders must be given an annual report, containing such financial statements for the preceding fiscal year as will, in the opinion of the management, adequately reflect the financial position and operations of the company. The proxy rules also supply protection where persons outside of management seek representation on the board of directors by requiring that such persons disclose adequate information as to their interests in, and proposals with respect to, the issuer and to make other disclosures similar to that required of management in their proxy solicitation material. All proxy material must be filed with the Commission for examination by the staff prior to use.

Section 16 of the Exchange Act is aimed at preventing the use by corporate officials of "inside" information for the purpose of speculating in the stock of their corporations. These practices were characterized as follows by the Senate Committee on Banking and Currency in its 1934 report on stock exchange practices:

"Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others." (S. Rept. 1455, 73d Cong., 2d sess. (1934 p. 55.)

The Exchange Act deals with this problem, insofar as it relates to securities traded on a national exchange, by three distinct but closely integrated approaches.

First, in conformity with the disclosure philosophy basic to all of the Federal securities acts, section 16(a) of the Exchange Act requires each insider of any issuer of listed equity securities to file with the Commission and the appropriate exchange an initial statement of his ownership of all equity securities of the issuer and monthly reports reflecting any subsequent changes. These disclosures are not only an important deterrent against the unfair use of inside information but, because they may reflect the opinion of management as to the value of the corporation's securities, they have also come to be a valuable source of information for investment decisions.

Because disclosure alone cannot be expected to curtail insider trading on the basis of inside information, the companion section 16(b) provides for the re-

covery, by or on behalf of a listed corporation, of all profits realized by an insider from short-term trading, i.e., a purchase and sale, or sale and repurchase, of the corporation's stock within any 6-month period. Section 16(b), with its automatic recovery provision, cuts through the formidable difficulties of proving intent and actual misuse of inside information that have frustrated the effectiveness of traditional remedies against insider speculation.

A third and very direct manner by which the Exchange Act deals with the insider trading problem is found in section 16(c). That section attacks favorite manipulative techniques of insiders—short-selling and selling against their position—by prohibiting insiders of listed corporations from selling shares they do not own, or if owned, from delivering, or depositing for delivery, such shares later than the times specified in the statute.

3. Need for disclosure in the over-the-counter market

Together, sections 12, 13, 14, and 16 provide essential protections for investors, but these protections are generally available only to investors in securities listed on a national securities exchange. They apply to over-the-counter securities only a fragmentary basis. Certain over-the-counter issuers which have filed registration statements under the Securities Act are required by section 15(d) of the Exchange Act to comply with the reporting requirements applicable to issuers of listed securities. However, only investors in registered public utility holding companies and registered investment companies are afforded protections comparable to those provided investors in listed securities.

There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market. Nothing in the nature of the securities traded in that market makes any less necessary the disclosure of basic information. On the contrary, because the over-the-counter market includes not only securities of widely known and seasoned companies but also those of relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great, if not greater than in the exchange markets.

The lack of the basic investor protection of disclosure in the over-the-counter market has made informed investment judgment difficult; it has created grave difficulties for brokers and dealers who try to fulfill their responsibilities to provide sound investment advice to the public; it has deprived investors of important bulwarks against fraud; and it has made it impossible for the over-the-counter market to enjoy a sustained expression of public confidence. Moreover, the disparity between the disclosure requirements of the exchanges and over-the-counter markets itself stands as an undesirable artificial factor in the allocation of securities between the two markets.

The Report of the Special Study is a documented analysis of the necessity for disclosure. The report demonstrates that irresponsible selling tactics, reckless investment advice, extravagant financial public relations and erratic markets for new issues of securities thrive best where lack of information is most marked. Persuasive confirmation of the need for more adequate disclosure is provided by investors themselves. The most significant number of public complaints received by the Commission concerns requests for information about over-the-counter companies with respect to which the public has little or no adequate information.

The public should not be asked to buy and sell in darkness, nor can professionals in the securities markets advise clients properly without reliable information. An analyst attempting to assess the investment worth of a company which does not file reports may be unable to find in the financial manuals adequate or reliable data. Moreover, as to nonreporting companies the information contained in these financial services may contain only that information which management chooses to make public. Thus, to furnish informed investment advice, an analyst must often expend considerable effort and incur substantial expense in making his own investigation which, at best, might be incomplete. A single such effort, moreover, will not suffice; the appraisal of securities must be a continuing process if financial data, once assembled, are to be kept sufficiently up to date to provide a reliable basis for advice or investment decision.

The potential for abuse created by the present lack of basic protections in the over-the-counter markets is reflected in the fact that the overwhelming preponderance of fraud cases before the Commission in past years has involved securities of companies not subject to the Commission's reporting requirements. The subject of fraud in the sale of over-the-counter securities is discussed in detail in the memorandum attached to this statement. Vigorous enforcement of

the antifraud provisions of the securities laws by the Commission cannot be an adequate substitute for basic preventive measures, which would be far less costly both to taxpayers and victimized investors.

The availability of reliable sources of current information has been a vital protection against fraud in listed securities. It enables responsible broker-dealers and investment advisers to evaluate thoroughly information furnished to them by issuers and other sources. It deprives unscrupulous broker-dealers of the defense, frequently encountered by the Commission in its enforcement efforts, that the dissemination of false and misleading information was due to the failure of the issuer and its management to make adequate and accurate disclosures. Members of the investing public also have an opportunity to protect themselves against fraudulent sales campaigns by checking representations made with the reservoir of information concerning issuers and their securities contained in reports and other documents filed with the Commission and distributed to shareholders.

The requirement of periodic disclosures, in and of itself, often serves as a powerful deterrent against fraud and other abuses. Moreover, the reporting and proxy provisions of the Exchange Act often extend protection to areas which the antifraud provisions of the Federal securities laws do not reach. For example in the recent case of *U.S.* v. *Pope*, 189 F. Supp. 12 (S.D.N.Y., 1960), defendants diverted over $400,000 of assets from a publicly owned listed corporation, which they controlled, to one of their privately held corporations. The failure to disclose these transactions in proxy statements, as required by the Commission's proxy rules, resulted in their criminal conviction for violations of these rules and restitution by the defendants of the entire amount diverted. Because the diversion of assets did not relate to securities transactions, the Commission would have had no jurisdiction to prosecute this abuse if the company had not been subject to the Exchange Act's disclosure requirements.

Experience demonstrates that the disclosure requirements of the Exchange Act applicable to listed securities have been of considerable assistance in the detection, investigation, and prosecution of violations of the Federal securities laws. In some instances, the information disclosed in reports filed with the Commission provides the first suggestion of a possible violation of these laws. Information filed with the Commission is also important when the Commission receives a complaint letter or charges from other sources as to violations. When these allegations relate to a reporting company, the availability of reports and other required filings with respect to these companies makes evaluation and investigation a speedier and more efficient task. Prompt enforcement efforts are essential for the protection of the investing public.

The requirement of periodic disclosure makes concealment by corporate manipulators and fraudulent stock promoters difficult. When they have simply ignored the filing requirements, Commission investigations, initiated because of the delinquency, have uncovered serious fraud and other misconduct. Even when false information is filed with the Commission and is initially undetected, reporting requirements can subsequently lead to disclosure and appropriate action. In some cases, discrepancies have been noticed by the company's public accountants while engaged in an annual audit for the preparation of reports to be filed with the Commission; in other instances, comparison by the staff of current information with the reservoir of previous reports, proxy solicitation materials, and registration statements has disclosed suspicious circumstances and has led to the uncovering of abuses by corporate management.

The over-the-counter market has undergone a spectacular growth in the last decade. The average number of stocks quoted in the "daily sheets" of the National Quotation Bureau, circulated among dealers in the over-the-counter market, increased from 5,000 in 1946 to 8,200 as of January 15, 1963. Moreover, during a 10-month period in 1961 and 1962, quotations were entered in over 14,000 different domestic stocks traded exclusively in the over-the-counter market. In addition, over-the-counter sales of corporate stocks, excluding sales of mutual fund shares and syndicated distributions, increased almost 700 percent in 12 years—from an estimated $4.9 billion in 1949 to $38.9 billion in 1961. Considering both public sales and sales between dealers, the estimated dollar volume of over-the-counter transactions rose from 16 percent of the volume on all national securities exchanges in 1929 to 61 percent in 1961.

Companies with stocks traded exclusively in the over-the-counter market constitute an important sector of our economy. The Special Study's sample of over 1,600 of these companies showed that 31 percent had assets of over $10

million, 47 percent had assets over $5 million, and 77 percent had assets of $1 million or more. About one-half had 500 or more shareholders and 16 percent had 2,000 or more.

The importance of the over-the-counter market is further reflected in the fact that, considering only public sales, the volume of over-the-counter stock transactions in 1961 amounted to approximately 75 percent of exchange transactions in terms of shares and 35 percent in terms of dollars.

Thus the over-the-counter market has become an important institution for the channeling of investor capital into the Nation's business enterprises. Nevertheless, because of the crucial disparity of available information between securities traded on the exchange and in the over-the-counter market, that market fails to receive the measure of public confidence which it might otherwise enjoy.

Experience under the Federal securities laws has proven that providing basic investor protections encourages a healthy development of the securities markets. If the present double standard is eliminated, investor confidence in the over-the-counter market should be increased and the ability of companies to raise necessary capital should be enhanced. Moreover, a determination whether a security should be registered on an exchange or traded exclusively in the over-the-counter market will no longer be affected by such extraneous factors as the disclosure requirements now applicable to issuers of securities traded in the exchange markets. Securities will gravitate to the market best suited to them.

The need of the over-the-counter market for the benefits offered by this legislation is clear. The report of the House Committee on Interstate and Foreign Commerce on H.R. 11670, 87th Congress, 2d session (1962), concerning the extension of the reporting date of the Special Study makes the following statement concerning disclosure by over-the-counter companies:

"Under the present law a large number of issuers in whose securities there is substantial public interest are not subject to any reporting requirements. Thus, the investing public is deprived of material financial information with respect to these companies. On the basis of this inquiry [the Special Study], the Commission expects to determine the appropriateness of existing distinctions in the regulation of issuers with listed securities and unlisted securities, particularly with respect to publication of reports, solicitation of proxies and insiders transactions." (H. Rept. 1778, 87th Cong., 2d sess. (1962), pp. 6, 7.)

On three previous occasions, in 1946, 1950, and 1956, Commission surveys have shown that the financial reporting practices of over-the-counter companies were seriously deficient and that disclosures in proxy solicitations were even more inadequate. The need to provide disclosure requirements for these companies has not diminished. Another comprehensive examination made by the Special Study confirms the previous findings. Moreover, there is no voluntary substitute for the protections against insider trading abuses provided by section 16 of the Exchange Act.

The Special Study used, as a sample, 1,618 over-the-counter companies which responded to questionnaires sent to every fifth company listed in the January 1962 monthly summary of the National Quotation Bureau, excluding listed companies and foreign companies. Half of these 1,618 companies were asked to submit copies of all financial reports and proxy materials submitted to shareholders during 1961. Replies were received from 771 companies, comprising 171 banks, 44 insurance companies, and 556 industrial and others.

Excluding banks and insurance companies, which are discussed below, more than 25 percent of the remaining 556 companies did not distribute financial reports of any kind to stockholders. The Commission's proxy rules require that, if management solicits proxies for a meeting at which directors are to be elected, the proxy material must be preceded or accompanied by the company's annual report containing financial statements for the preceding fiscal year. Section 5(c) of the bill would require also that, in the event proxies are not solicited, shareholders be furnished, prior to any meeting, with information substantially equivalent to the information which would be required in a proxy solicitation.

In the 75 percent of the cases where financial statements were furnished, the Special Study found serious deficiencies. Forty-four percent of these companies failed to classify inventories. The method of evaluating inventories was not stated in 26 percent of the financial statements. Explantory notes were not included by 33 percent of these companies in cases in which Commission regulations would require this disclosure for such items as depreciation methods, long-time contractual obligations, outstanding options, contingent liabilities and significant nonrecurring items. Twenty-three percent of the financial state-

ments dstirbuted were not certified by an independent public accountant, a basic requirement of Commission accounting regulations.

The Special Study's examination of proxy solicitation practices of these same 556 companies revealed more striking deficiencies. Twenty-nine percent did not solicit proxies, and 24 percent did not even send shareholders a notice of meeting. Of the 417 companies that did solicit proxies, 379 solicitations related to meetings involving election of directors. In 73 percent of these cases shareholders where not told the names of the nominees and in 42 percent of the cases where nominees' names were disclosed, their experience was not. Remuneration of management was not disclosed in 95 percent of the cases. These are items of basic information as to which the Commission's proxy rules would require disclosure in all solicitations involving election of directors.

Proxy solicitations on matters other than the election of directors were also inadequate. The opportunity for a yes or no vote, as required by the Commission's proxy rules, was frequently not afforded. Reasons for a proposed amendment of bylaws or charters, explanations of the effect of proposed modifications of securities, and material facts concerning option plans or the issuance of warrants or rights were not stated. These disclosures would be required by the Commission's proxy rules.

The findings of the Special Study indicate that disclosure practices tend to improve in larger companies with a greater number of equity-security holders. This improvement would be reflected in companies with over $1 million of assets and 500 or more equity-security holders that would be covered by the bill. Nevertheless, significant inadequacies were found in the disclosure practices of companies in this category which were included in the Special Study survey. Thirteen percent did not distribute any financial statements to shareholders in 1961. Of those that did, in 12 percent of the cases the financial statements were not certified by an independent public accountant, and in 17 percent of the cases there were no explanatory notes which are necessary to clarify various items.

The proxy solicitation practices of these larger companies show even greater need of improvement. During 1961 no proxy material was furnished to stockholders by 17 percent of these companies. Sixty-two percent of the companies soliciting proxies for election of directors did not disclose the names of nominees and 92 percent made no disclosure of the remuneration of management. Significant deficiencies were found in many other respects.

Many companies that would be covered by the bill do make adequate disclosures to their shareholders. The bill would have little effect on these companies. But the extent of the public interest in companies with over $1 million of assets and 500 or more holders of a class of equity securities requires strong assurance that the information disclosed by them is, and will continue to be, current, adequate, and susceptible to comparative evaluation. Virtually every segment of the financial community and important segments of the business community, many of which previously opposed legislation similar to the bill, now agree that this can be achieved only by requiring disclosure under statutory sanctions and subject to examination by an independent agency for compliance with accounting and other disclosure standards. In the absence of statutory requirements, it cannot be expected that corporate managements, in times of stress—when the need for full and accurate disclosure is most marked—will always voluntarily disclose matters which may tend to reflect adversely on their activities or their companies.

Furthermore, there is no voluntary disclosure of insider trading comparable to that which would be required of those larger companies under section 16(a) of the Exchange Act. As the Special Study pointed out, and as is further discussed below, the need of investors in over-the-counter securities for protections against insider trading abuses may be even greater than that of investors in listed securities.

The extension of the disclosure requirements of the Exchange Act to a significant portion of the over-the-counter market undoubtedly will have an effect in the entire market. The initial application of the disclosure philosophy to trading markets on national securities exchanges has created an appreciation of, and an expectation for, regular and continuous information. For this reason, many over-the-counter companies, both large and small, have been persuaded that confidence can best be maintained by voluntarily making adequate disclosures to shareholders. Enactment of the bill should greatly accelerate this trend.

SUMMARY OF THE DISCLOSURE AND RELATED PROVISIONS OF THE BILL

Standards for coverage

The bill would extend sections 12, 13, 14, and 16 of the Exchange Act initially to those companies having over $1 million in assets and 750 or more holders of record of any class of equity securities. After a 2-year period, or such later date as the Commission may determine, the equity-security holders test would be reduced to 500. It is estimated that under the 750 equity-security holders standard, approximately 3,100 companies would be covered, of which about 400 would be banks. About 1,500 of the remaining 2,700 are already required to file reports with the Commission under section 15(d) of the Exchange Act. Under the 500 equity-security holders standard, the estimated figures are 3,900 companies covered, 600 banks, and 1,700 companies already reporting.

The staggered basis upon which the coverage provisions of the bill would become operative provides a reasonable period for preparation by the issuers involved and permits gradual assumption by the Commission of the administrative burden.

The selection of a standard of coverage, necessarily a matter of judgment, is based on several factors. In principle. the registration, reporting, proxy, and insider trading provisions of the Exchange Act might be applied to all over-the-counter issuers in which public investors have an equity interest. Under the Securities Act an offering to a very small number of persons may be "public" if they need the protection of disclosure, and by parity of reasoning it may be argued that any company with a similarly small number of outside stockholders should be included in the protective legislation. Under the Investment Company Act of 1940, Congress set 100 shareholders as the standard for measuring the public interest. Such inclusive coverage might, however, create a burden on issuers and the Commission unwarranted by the number of investors protected, the size of companies affected, and other factors bearing on the public interest. Unlike the Securities Act, which requires filing only on the occasion of an offering, the Exchange Act requires at least annual filings. It is therefore necessary on purely practical grounds to limit in some manner the number of issuers required to comply, so that the flow of reports and proxy statements will be manageable from the regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest to be served.

The Commission strongly believes that the standards contained in the bill are appropriate ones. They are recommended by the Commission after consideration of the burden on the issuers, the administrative burden on the Commission, and the public interest to be protected. The findings of the Special Study indicate the large public interest in issuers that will be encompassed by the proposed legislation. The trading activity of these issuers, as measured by record transfers and broker-dealer interest, becomes significant for a majority of the issuers affected. Seventy-seven percent of the issuers covered by this bill had 200 or more transfers in 1961. The importance of the issuers at the proposed level is again reflected by the interest of the broker-dealer community; two or more broker-dealers expressed an interest in the securities of 74 percent of the issuers that would be covered by the proposed legislation.

The standards contained in the bill are higher than the coverage recommended by the Special Study, which was based solely on a test of 300 or more holders of a class of equity securities. However, the standards contained in the bill will significantly lessen the administrative burden by reducing the number of issuers that will be required to comply. At the same time, by including most companies in which the public is interested, the bill would still protect the great majority of investors in the over-the-counter market. The $1 million asset test would eliminate about 17 percent of the over-the-counter companies with 500 or more equity-security holders.

At the hearings on S. 1642 before the Subcommittee on Securities of the Banking and Currency Committee of the U.S. Senate, the Investment Bankers Association of America (IBA), the National Association of Securities Dealers, and the Association of Stock Exchange Firms proposed modifications of the provisions for disclosure by companies in the over-the-counter market.

It was suggested that the registration, reporting, proxy, and insider trading provisions of the Exchange Act be applied only when the number of stockholders exceeds 1,000. The IBA also proposed that over-the-counter companies having more than 300 stockholders, apparently without reference to their size, be required to furnish reports to stockholders. These reports would not be filed with

or examined by the Commission, but the content and frequency of such reports would be prescribed by Commission rules. This reporting requirement would be enforced by civil or criminal penalties, including injunctions. The stockholder reports would include audited balance sheets and statements of earnings and surplus, all prepared in accordance with generally accepted accounting principles.

If the test of 1,000 stockholders were substituted, about 2,500 companies, including about 320 banks, would be subject to sections 12, 13, 14, and 16. Of these, approximately 1,100 are reporting under section 15(d) of the Exchange Act. Thus, the change from 500 stockholders [4] to 1,000 would exclude from coverage about 1,400 companies, including about 280 banks. The Commission estimates that securities of these issuers are held by approximately 1 million investors.

On the other hand, upon the basis of Special Study figures, these proposals would subject to the modified stockholder reporting proposal approximately 7,000 companies so that the bill would have an impact upon approximately 3,000 more companies than it now does.

The proposals for raising the shareholder test to 1,000 appear to be based upon the assumption that the 1,400 companies to be excluded are small businesses as to which compliance with sections 13, 14, and 16 would be unduly burdensome. However, the data assembled by the Special Study indicate that about 55 percent of the companies having between 500 and 1,000 stockholders and in excess of $1 million of assets in fact have assets of more than $5 million and that 25 percent have assets of $20 million and over. Only about 20 percent have assets between $1 and $2 million. The average company in this group, excluding insurance companies and banks, had assets of $12 million. If insurance companies and banks were included, the figure would be substantially greater. It is clear that by any standard the companies with between 500 and 1,000 shareholders represent substantial enterprises. In addition, the Commission believes that the primary test in selecting coverage standards for inclusion in the bill should be the public interest as measured by the number of shareholders. A company with between 500 and 1,000 shareholders represents a substantial public interest. The asset test is designed to assure that no disproportionate burden is placed either on the companies or on the Government in relation to the public interest to be served.

The proposal to raise the coverage standard to 1,000 shareholders would also deprive investors in the excluded companies of the protection afforded by the proxy solicitation and insider trading provisions.

Of the companies having between 500 and 1,000 stockholders covered by the Special Study survey, approximately 16 percent did not solicit proxies. Where directors were to be elected, 74 percent did not provide the names of the nominees and about 90 percent did not give their evperience. Where proposals were to be voted upon, approximately 60 percent did not provide an opportunity for a yes or no vote.

The insider trading provisions of section 16 of the Exchange Act apply only to insiders of corporations and impose no burden on the companies. There is no basis for a conclusion that insiders in these particular companies have any greater need to engage in short-swing trading than insiders in other companies subject to the bill.

While the Commission agrees that it might be desirable for companies having more than 300 equity-security holders to be subject to appropriate reporting requirements, it believes that the approach of section 15(d), as proposed to be amended (which would require companies with 300 or more record security holders filing Securities Act registration statements thereafter to file reports on a continuing basis with the Commission) would avoid the considerable administrative and enforcement difficulties involved in a requirement that such companies send annual reports, including audited financial statements, to their shareholders without filing a copy with the Commission.

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[4] The coverage figure in the bill is 500 or more holders of any class of equity security. As discussed earlier, the term "equity security" is broader than the term "capital stock" in that "equity security" includes capital stock and, inter alia, convertible debt instruments—but nonconvertible debt instruments without warrants or rights attached are not equity securities. The IBA proposal was worded in terms of stockholders rather than equity-security holders, although it is not clear whether the reference would necessarily be limited to stockholders. For convenience, in the paragraph to which this note relates and the next following four paragraphs of this statement, both the IBA proposal and the test contained in the bill will be phrased in terms of stockholders, although the bill is tied to the number of equity-security holders.

Banks

Banks are now subject to the provisions of the Exchange Act, and banks having over-the-counter securities and meeting the statutory standards are included within the coverage of the bill. However, S. 1642, as reported by the Committee on Banking and Currency of the U.S. Senate and as passed by the U.S. Senate, mandates the vesting in the appropriate Federal banking regulatory agencies of the Securities and Exchange Commission's disclosure, proxy, and insider trading powers, functions and duties with respect to bank securities. H.R. 6789, H.R. 6793, and S. 1642 in its introduced form would leave such powers, functions, and duties in the Commission until the bank regulatory agencies request them, at which time the Commission would be bound to transfer them to such agencies. Thus, each of the bills would, by somewhat different formulas, extend disclosure protection to investors in bank securities and at the same time permit their integration with the safeguards for depositors provided by the Federal banking regulatory structure.

On December 30, 1962, there were 13,951 banks in the United States; 496 were noninsured State banks responsible only to their respective State banking authorities, 6,048 were members of the Federal Reserve System and the remainder were insured banks subject to the jurisdiction of the Federal Deposit Insurance Corporation. Of the banks which were members of the Federal Reserve System, 4,510 were national banks, which are under the jurisdiction of the Comptroller of the Currency.

The great majority of all these banks are not of sufficient investor interest to fall within the statutory standards of coverage under the bill. Bank stocks however constitute an important segment of the over-the-counter market, accounting for approximately one-fifth of the securities listed in the 3-month period covered by the January 1962 summary of the National Quotation Bureau. The Special Study's data indicate that over 600 banks have assets in excess of $1 million and have 500 stockholders or more of record. Moody's Bank and Finance Manual for 1963 lists about 558 banks in that category, with the market value of their outstanding securities as of December 31, 1962, aggregating $22.5 billion and their shareholders (without allowance for duplication) totaling approximately 1,600,000. Thus, the securities of the banks subject to S. 1642 represent a substantial capital investment by a large segment of the investing public.

The coverage standards of the bill ($1 million total assets and 750 equity-security holders, later reduced to 500 equity-security holders) would apply equally to all types of campanies, including banks. The tests are designed to eliminate from coverage less substantial companies as to which administration of the provisions of the bill might be disproportionately burdensome on the Commission and issuers in relation to the public interest to be served. In arriving at these standards, the Commission considered the use of a number of alternatives. Although some of these alternative standards might, after further study, be found appropriate for particular companies or industries, the Commission decided that the bill should contain a uniform coverage standard as a measure of investor interest, especially in light of the provisions of the bill that allow the Commission (or a bank regulatory agency in the case of banks under its jurisdiction) to exempt or classify issuers.

The $1 million total asset test will exclude very few banks, since the cash received by banks as deposits will be considered an asset for this purpose. On the other hand, since bank stocks tend to be closely held, the 500 equity-security holder test excludes all but 600 of the 13,951 banks in the United States. The bill would reach, however, about 36 percent of bank securities—as compared to about 35 percent of all over-the-counter securities—which evoked some trading interest during a 10-month period covered by the study. Thus, the equity-security holder test alone serves the same exclusionary purpose for banks that the combination of the equity-security holder and the asset tests serves for over-the-counter companies generally. If a bank regulatory agency should find that it is desirable to exempt certain smaller banks covered by the bill, it would have authority to do so. Conversely, since the bill does not limit the general authority of the Federal bank regulatory agencies, any one of them could exercise any such authority to extend disclosure requirements to banks that would not be covered by the bill.

Under the pattern of existing bank regulation, all national banks are members of the Federal Reserve System, but fall principally under the supervisory jurisdiction of the Comptroller of the Currency; those State banks which are Federal

Reserve member banks are regulated primarily by the Federal Reserve Board; and State banks which are insured by the Federal Deposit Insurance Corporation but which are not members of the Federal Reserve System must comply with the regulations of the Federal Deposit Insurance Corporation. Generally all banks must submit to at least one examination annually and reports of condition are required to be submitted four times a year by the appropriate Federal agency and at least annually by State authorities. Members of the Federal Reserve System must report earnings and dividends annually to the Federal Reserve Board, and national banks report earnings and dividends to the Comptroller under his current regulations. Those insured banks which do not report to either the Comptroller or the Federal Reserve are required to report earnings and dividends annually to the Federal Deposit Insurance Corporation. Neither the statements required to be filed nor the results of the examinations are available to the public. Historically, they have been oriented to the protection of depositors rather than the investor, whose obvious foremost need is for the disclosure of financial information which will facilitate the making of informed investment decisions.

The Special Study's analysis of the current financial reporting and proxy solicitation practices of banks revealed that, as is true of over-the-counter companies generally, most over-the-counter banks fall short of the standards provided for the protection of investors by the rules adopted by the Commission under existing provisions of the Exchange Act in respect of listed companies. Ten percent of the responding banks covered by the bill sent no financial material to their shareholders. Of the 90 percent that did, 32 percent failed to include a profit-and-loss statement. Thus, approximately 40 percent of the bank materials examined by the Special Study and published by banks which would be covered by the proposed bill failed to provide any significant basis for investment decisions.

The Study examined the proxy material of banks that would be subject to the bill. This material related to a total of 50 meetings, 43 annual and 7 special. In 88 percent of the solicitations involving elections of directors, the names of the nominees were not stated; in 95 percent of such cases their experience was not stated. In no case was the remuneration of management given. Other deficiences included failure, in all cases examined, to state reasons for the amendment of bylaws or charters, and failure to provide shareholders with an opportunity, as would be required by the Commission rules, for a "yes" or "no" vote on major proposals in 31 percent of the cases.

In its report the Special Study concluded that the investor protections of sections 13, 14, and 16 (relating to disclosure, proxies, and insider trading, respectively) of the Exchange Act "are needed for bank shareholders as well as other shareholders" and that "banks meeting the recommended criterion should be included in the recommended legislation."

The Commission strongly supports this recommendation of the Special Study. The question really is: Do investors in bank stocks need this protection any less than other investors? The Commission emphatically believes the answer to be "no" and strongly recommends that investors in bank stocks be given the basic protections afforded by the bill.

In the Senate hearings on S. 1642, support for the inclusion of banks in the bill came from many quarters.

Mr. Keith Funston, president of the New York Stock Exchange, stated that it is "absolutely essential that requirements affecting the banks should be the same whether the bank stocks are listed or unlisted." Similar views were expressed by the American Stock Exchange and the National Association of Securities Dealers, Inc. All major securities industry groups supported the inclusion of banks.

M. A. Schapiro, a broker-dealer specializing and recognized as an authority in bank stocks, strongly supported the coverage of banks under the bill. In the Bank Stock Quarterly for March 1962 he has written:

"In the absence of any regulatory requirement for uniform reporting and disclosure to shareholders, banks frequently issue partial or distorted statistics which make it difficult if not impossible for investors to make intelligent decisions."

The Chairman of the Board of Governors of the Federal Reserve System, Mr. Martin, supported the inclusion of banks in the following statement:

"The commercial banking system is one of the most closely supervised industries in the United States, subject to numerous laws and regulations, detailed

examination, and requirements of reports to bank supervisors, both State and Federal. The objectives of bank supervision, however, are fundamentally different from those of the Securities Exchange Act. Bank supervision is intended to assist in maintaining a sound, serviceable banking structure and to protect bank depositors. As an incident to these principal functions, supervision also benefits bank shareholders in important ways. Nevertheless, most of the information about a bank that is developed by the supervisory authorities must necessarily be treated by them as confidential, and the data now available to a bank's shareholders or prospective shareholders do not appear to provide all that they would need in order to make sound investment decisions.

"Congress has sought in the Securities Acts to assure the availability of information that would enable members of the public to make their own decisions intelligently. This seems to us a very sound principle, and just as applicable to bank stocks as to other stocks. Furthermore, the Board feels that stockholders in banks are entitled to the protection of the insider trading provisions of the Securities Exchange Act."

The American Bankers Association requested no exemptions for bank securities and supported the disclosure, proxy, and insider trading provisions of S. 1642, if the bill were changed from its introduced form to provide that administration of these provisions, so far as bank securities are concerned, be mandated to the respective Federal banking regulatory agencies. The association indicated that, in its opinion, these provisions of the bill, insofar as banks are concerned, should be integrated with the other Federal controls over banks and that this should be done through the administration of these provisions of the bill by the respective Federal banking agencies with primary examining and supervisory authority—the Comptroller of the Currency for national banks; the Federal Reserve Board for member State banks; and the FDIC for nonmember, insured State banks. The association pointed out that this system would minimize the number of Federal regulatory agencies that banks report to and would permit more complete integration with other regulation. The association also pointed out that S. 1642, in its introduced form, might lead to the undesirable situation where one agency would request and obtain the powers with respect to banks under its jurisdiction with another agency not requesting the powers for banks under its jurisdiction causing the powers in regard to the latter category of banks to remain in the Commission. The Chamber of Commerce of the United States agreed with the American Bankers Association.

The Federal Deposit Insurance Corporation, while favoring full and proper disclosure by banks, registered opposition to S. 1642 in its introduced form and favored a formula along the lines of S. 1642 as passed by the Senate for administering any new disclosure provisions applicable to bank securities.

Mr. Saxon, Comptroller of the Currency, stated that he favors the principle of disclosure and that his rules and regulations in the area, which now require considerable disclosure by a large number of national banks, are also being expanded in the areas of proxy statements and insider trading. Mr. Saxon said, however, that S. 1642 is not needed insofar as bank securities are concerned, since the various Federal bank regulatory agencies, in his opinion, now have sufficient legal authority to act in these areas. Mr. Saxon also stated that if Congress decides that more statutory authority is needed, that increased statutory authority should be provided in the various Federal banking laws. Mr. Saxon indicated apprehension, which the Commission believes is unjustified, that if authority is given to the Federal bank regulatory agencies under the securities laws, reference will always be made to those laws and interpretations thereunder for testing the adequacy of the regulations of the bank agencies. Mr. Saxon has stated that, as between the Securities and Exchange Commission and the various Federal bank regulatory agencies, the latter should have jurisdiction over disclosure, proxy, and insider trading provisions relating to banks.

As noted earlier, the Federal Reserve Board supported the inclusion of banks. The Board, however, stated that the Commission should administer the provisions of the bill with respect to banks.

The Committee on Banking and Currency of the U.S. Senate concluded that S. 1642 should be amended, as recommended by the American Bankers Association and the U.S. Chamber of Commerce, to mandate the powers, functions, and duties of the Commission to administer and enforce sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act to the respective Federal banking regulatory agencies. That committee found "most persuasive the reasons advanced by the asso-

ciation [the American Bankers Association], which directly represents the institutions most directly affected."

The Commission had earlier stated to that committee that it would have no objection to such a revision, since the Commission's interest is in establishing the principle of disclosure, proxy, and insider trading requirements for over-the-counter bank stocks in which there is public interest and not in expanding the Commission's jurisdiction. The form of S. 1642 as introduced manifested that attitude, as it would have allowed the respective Federal banking agencies, at their option, to obtain jurisdiction; the only effect of the Senate change is to mandate that jurisdiction to those agencies. The Commission believes that the Senate amendment to S. 1642 is a very appropriate way of dealing with the problem.

The Commission believes that it would be undesirable either (1) to exclude banks completely from the bill and rely upon the general regulatory authority of the banking agencies under other provisions of law, or (2) to exclude banks from the bill and place provisions similar to the disclosure, proxy, and insider trading provision of the bill in each of the Federal banking laws. The provisions of the Securities Exchange Act for this purpose are comprehensive and have proven themselves in practice. To devise appropriate substitutes to insert into each of the Federal banking laws might give rise to unnecessary problems of administration and interpretation. Also, while the Comptroller of the Currency has made considerable pioneering headway in these areas under his general regulatory authority, the Commission believes it more desirable that the authority of the banking agencies in these areas be made express. It is noted that the provisions of the bill in no way derogate or limit other provisions of law giving banking agencies authority to regulate banks within their respective jurisdictions.

The disclosure, proxy, and insider trading provisions of the Securities Exchange Act of 1934, especially as would be amended by the bill, provide great discretionary authority for an administering bank agency to make appropriate rules, classifications, and exceptions. Under these provisions, the Federal banking regulatory agencies could adopt rules and forms differing from those of the Commission relating to companies other than banks, whenever the banking regulatory agencies deem it appropriate.

The Commission's experience indicates that a bank regulatory agency administering sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act with respect to securities of banks under its jurisdiction will seldom become involved in cumbersome administrative proceedings. In the administration and enforcement of section 14 (proxies) and section 16(a) (insider trading reports) no formal administrative proceedings whatever are provided for. The Commission now administers and enforces these provisions informally by requesting filings and by commenting on material submitted. The bank regulatory authorities may do the same. If these methods do not satisfactorily dispose of any problems, the Commission's only remedies are to institute delisting proceedings or to file an action in the Federal courts. It is likely that the relationships between the Federal bank regulatory agencies and the banks under their jurisdiction are such that it will rarely, if ever, be necessary for these agencies to resort to these remedies.

With respect to sections 12 and 13 (registration and reporting), section 6(c) of the bill permits the Commission or other administering agency to resort to an administrative proceeding leading essentially to a declaratory order. This remedy would be useful to the Commission in formally developing a record with respect to controversial filings. No bank agency need resort to this procedure unless it deems this necessary, and presumably the bank regulatory authorities will rarely do so. Section 21, providing for investigations and court proceedings, need not be utilized by any administering agency unless it determines that this is necessary in order to perform its functions; and section 19 will have no application to bank securities unless they become listed on a national securities exchange. Section 16(b) is not enforced by any Government agency. In summary, and in accordance with the policy expressed in section 5(b) of the Administrative Procedure Act, the Commission in its administration of sections 12, 13, 14, and 16(a) has emphasized informal procedures for procuring compliance, and bank regulatory agencies, by reason of their relationships to the banks under their jurisdiction, would seemingly be able to do so to an even greater extent.

Insurance companies

Just as the bill contains no exemptions for securities of banks or public utilities, both of which are heavily regulated by State and Federal agencies, it also contains no exemption for securities of insurance companies, which are and have always been subject to all of the provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933. Insurance companies constitute a significant segment of issuers whose securities are traded in the over-the-counter market, comprising about 5 percent of the domestic issuers of securities listed in the January 1962 Monthly Summary of the National Quotations Bureau. Indeed, the report of the Special Study indicates a more widespread public shareholder interest in insurance company securities than in the securities of over-the-counter issuers generally. Of the 96 insurance companies included in the sample of over-the-counter companies utilized by the Special Study, 73 percent reported 500 or more record shareholders and 59 percent reported 1,000 or more record shareholders. In contrast, only 48 percent of all the 1,610 over-the-counter issuers surveyed reported 500 or more record shareholders, and only 29 percent reported 1,000 or more record shareholders. In addition, 93 percent of the insurance companies had $1 million or more in assets and 59 percent had assets of $5 million or more, whereas of all issuers surveyed, 78 percent had assets of $1 million or more and 47 percent had assets of $5 million or more.

The bill would cover about 400 widely held stock insurance companies, of which about a third are already subject to the Commission's periodic reporting rules under sections 15(d) and 13 of the Exchange Act. The equity-security holder requirement for coverage (750 equity-security holders—later to be reduced to 500) insures that the bill will apply only to insurance companies which are widely held and in which there is a substantial investor interest. The information available on these 400 companies indicates that they have over 1,300,000 shareholders and that the market value of their outstanding shares is over $20 billion. Thus, these insurance companies represent substantial centers of investor interest in the over-the-counter market.

Mutual insurance companies would not be covered by the bill. This does not constitute discrimination in favor of mutual insurance companies. They have no shares being traded and therefore the same need for investor protection does not exist for them.

The Special Study's examination of proxy and financial disclosure policies of insurance companies shows that their shareholders need the investor protections afforded by the bill just as much as do shareholders of other companies.

Of the surveyed insurance companies which would be covered by the bill, 12 percent failed to send any financial reports to their stockholders; 50 percent of those that sent financial material failed to include a profit-and-loss statement; and 83 percent failed to include any explanatory notes to their financial reports.

Insurance company shareholders have also been deprived of information adequate for the exercise of their corporate franchise. Of the surveyed insurance companies that would be covered by the bill, 8 percent did not send any proxy material to shareholders. The proxy material examined by the Special Study related to 34 meetings. In the majority of instances where shareholders were given an opportunity to vote, the information provided was inadequate by the standards presently applicable to exchange-listed companies. There were 30 solicitations involving elections of directors; 73 percent of the solicitations omitted the names of the nominees; and in 83 percent the experience of the nominees was not stated. In other corporate matters requiring shareholder affirmation (e.g., options, mergers, and retirement plans) not one solicitation contained information which would have been required by the Commission's proxy rules.

The inadequacy of insurance companies' disclosure practices has been recognized by the financial community. A subcommittee within the National Federation of Financial Analysts Societies stated:

"It is our conclusion that annual reports [to stockholders] of the life insurance industry are the poorest of any major industry in the United States." (Twelfth Annual Report—National Federation of Financial Analysts Societies, p. 12 (1960)).

Considering the importance of insurance securities in the over-the-counter market and the poor reporting and proxy practices of insurance companies, insurance companies should be treated specially and excluded, thereby denying 1,300,000 shareholders holding $20 billion of shares in 400 widely held insurance companies the disclosure, proxy, and insider trading protections of the bill, only if there are very persuasive reasons for doing so.

The Commission sees no such reasons. Historically, insurance companies have never been exempted from either the Securities Act of 1933 or the Securities Exchange Act of 1934. Under the Securities Act of 1933, an insurance company distributing its securities to the public must file a registration statement with the Commission and comply with all of the provisions of that act, in the same manner as any industrial company. Likewise, under the Securities Exchange Act, an insurance company listing a security on a national securities exchange must comply with all of the provisions of that act applicable to exchange-listed companies. Presently two insurance companies have a security so listed and comply with those provisions of the act. Moreover, section 15(d) of the Exchange Act, added to that act in 1936, is fully applicable to insurance companies. That section requires an issuer distributing its securities to the public under a Securities Act registration statement to file periodic financial and other reports with the Commission if the value of the securities offered plus the value of all other outstanding securities of the class offered exceeds $2 million. Under section 15(d), approximately 148 insurance companies,[5] including about 96 life insurance companies, file periodic reports with the Commission. The market value of the shares of 126 of these companies (as to which information is presently available) is over $5 billion; their number of shareholders is estimated at approximately 700,000. In administering the Securities Act of 1933 and the Securities Exchange Act, the Commission has had considerable experience with the problems of insurance companies, and as discussed in more detail below, has administered the disclosure provisions of these acts in a way that has produced a minimum of burdens to the affected insurance companies.

The existing State regulation of insurance companies is aimed almost entirely at policyholder protection and is not an adequate substitute for investor-oriented protections of the type that would be provided by the bill.

State regulation furnishes nothing comparable to the proxy and insider trading protections that would be provided by the bill. The seriously deficient proxy practices of insurance companies that would be covered by the bill have been pointed out.

The extensive State examinations deal primarily with solvency; although certain periodic reports are filed with State officials and made matters of public record, many insurance companies often do not directly supply their shareholders with financial reports. As pointed out earlier, of the insurance companies that would be covered by the bill and that were covered by the study's examination, 12 percent failed to send any reports to shareholders and 50 percent of those that sent financial material failed to include a profit-and-loss statement, an indispensable tool for making an informed investment judgment. Under the bill, covered insurance companies would be obligated to send financial statements, including a profit-and-loss statement, to shareholders, either upon the solicitation of proxies or before annual or other meetings if proxies are not solicited. Although summaries of the statements filed with the State regulatory bodies would form the heart of the financial information filed with the Commission and sent to shareholders, the bill would assure that such information directly reaches shareholders.

Moreover, the bill would require certain nonfinancial information not now generally available under State insurance regulation to be filed with the Commission. For example, a State report, in comparison with the Commission's rules, typically contains only limited data concerning material transactions of insiders. Also, there is no provision in State regulation for current disclosure of events of major significance to investors such as mergers, acquisitions, and the issuance of substantial amounts of stock, whereas the Commission's form 8–K, the filing of which would be required by the bill, must be filed soon after the occurrence of any of these material events. This is information that is readily available and inexpensive to file, but which is of great value to investors.

The various disclosure requirements of the bill would also have a beneficial effect in protecting against overreaching—of importance in the insurance company industry where there has been extensive promotional activity. The insurance company business has expanded immensely in the last decade: from 1951 to 1961 life insurance firms in the United States have more than doubled,

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[5] These figures are as of June 30, 1962. As of June 30, 1963, the figure was 171 insurance companies reporting to the Commission; all but 2 were reporting under sec. 15(d). Breaking that figure down further, as of June 30, 1963, there were 114 life insurance companies reporting (all under sec. 15(d)) and 57 casualty insurance companies reporting—2 being listed on an exchange and 55 reporting under sec. 15(d).

from 659 to 1,457, with a high concentration of this growth in the South and Southwest. Many of these companies which emerged during this period were inevitably promotional to some degree and their activities posed problems of investor protection. In its 23d annual report (1957) this Commission, describing its most pressing enforcement problems, included this statement:

"Recent economic conditions have been relatively favorable for the sale of promotional stocks of new ventures, particularly in fields in which the securities of established enterprises have shown marked gains. For example, many new insurance and finance ventures have been promoted, particularly in the south central, southwestern, and southeastern parts of the country, and their securities have been distributed either through registration or regulation A, or more commonly, in reliance upon the intrastate exemption. Many of these issues and the sales techniques employed in their distribution appear to involve abuses and possible violations of the antifraud and other provisions of the Securities Act or the Securities Exchange Act, which require extensive investigation. The large number of these promotions and the rapidity with which they have increased has placed a most serious burden on the Commission's field enforcement personnel charged with the conduct of such investigations."

Similar statements were made in the 22d and 24th annual reports of the Commission, and these problems have not disappeared. In this connection, reference is made to the attached memorandum with respect to fraud in the sale of over-the-counter securities, and especially to part C thereof, which details certain recent fraud cases involving over-the-counter insurance companies.

The investor-oriented protections that would be provided by the bill and the State policyholder-oriented regulation are not mutually exclusive, nor does one impinge upon the other, for the bill imposes no controls over the internal operations, reserves, or business practices of insurance companies or of any other companies.

Under the Commission's practices with regard to reports of insurance companies under the Securities Exchange Act, covered insurance companies will have a minimum of difficulty—less than covered companies generally—in complying with these provisions of the bill. Insurance companies are, unlike most companies, not required to have their financial information submitted to the Commission certified by independent public accountants and are not required to submit semiannual reports. Moreover, to the extent that information required by the Commission's annual report form, form 10–K, is included in insurance companies' annual statements submitted to the State regulatory officials, these statements are accepted by the Commission in satisfaction of its requirements.

The Commission's annual report form under the Securities Exchange Act, form 10–K, requires no information, except for certain supplementary reconciliations and explanatory notes, from insurance companies that is not contained in the annual statement to State regulatory officials; indeed any deviation therefrom must be specifically noted. The main difference between form 10–K and the annual statements submitted to State regulatory officials is that the former is more simplified and, in general, contains less information than the latter.

The explanatory notes required of insurance companies in the Commission's form 10–K relate to matters such as (i) the manner in which liabilities and reserves for unearned premiums, losses, and claims are determined, (ii) information about pension and stock option plans, and (iii) restrictions on surplus with respect to payment of dividends to shareholders. In addition, there is required a historical analysis of surplus, for the benefit of investors not conversant with insurance accounting practices and terminology. Information about all of these matters is readily available and its insertion presents no significant burden. In addition, casualty insurance companies are required to submit supplementary reconciliations to show the differences in shareholders' equity and net income as reported in the reports to State regulatory bodies and as determined in accordance with generally accepted accounting principles. These supplementary reconciliations are not required of life insurance companies.

Because of the numerous life insurance companies subject to the Securities Acts, the Commission has recently proposed the adoption of new article 7A to its regulation S–X (the Commission's general accounting regulation) specifically governing their financial statements. Comments have been received on the proposal, and as revised, the Commission will act on its adoption after further conferences with the industry.

Article 7A will, in the main, codify the above-described practices of the Commission with respect to life insurance companies. It will not prescribe any method of reporting that is inconsistent with the methods prescribed in the an-

nual statement blank adopted by the National Association of Insurance Commissioners. Consistent with the Commission's present practices, the proposed article does not require the reporting of any financial information to the Commission which cannot be obtained out of the uniform NAIC annual statement or which is not otherwise readily available. The basic difference will continue to be that the Commission will require substantially less information than that included in the NAIC statement blank. The explanatory notes that will be required are, in essence, those now required. As at present life insurance companies would not be required to file the supplementary reconciliations of income and surplus required of casualty insurance companies.

Thus, the Commission has not required the life insurance companies now filing reports with it under the Securities Exchange Act to alter their accounting practices, and the passage of the bill would not require covered life insurance companies to do so.

As has been discussed earlier, the costs for covered companies in complying with the bill will be minimal, especially when compared with the benefits of adequate disclosure provided by the bill. Separate surveys of securities lawyers and accountants by two leading national securities exchanges indicate that the cost of compliance for smaller industrial companies would, except in the most unusual circumstances, be $1,500 to $3,000 per year, and perhaps even less. The modifications the Commission has made for insurance companies—the exemption from the generally applicable requirement of financial statements certified by independent public accountants, the exemption from the generally applicable requirement of the filing of semiannual reports, and the Commission's practice that, to the extent that data required by form 10–K is included in statements submitted to State regulaory officials, the information contained in such statements is accepted in satisfaction of its requirements—have been noted. Moreover, insurance companies (especially those that are sufficiently large to be covered by the bill) presumably have adequate staffs to cope with the reporting requirements of State regulation. Because the Commission does not require insurance companies to file financial statements certified by independent public accountants, the filings with the Commission could be handled by internal staffs with a minimum of outside professional services. The combination of these factors indicates that the compliance costs for the approximately 400 widely held insurance companies that will be covered would be far less than the moderate costs for covered companies generally. Also, of the estimated 400 insurance companies that would be covered by the bill, 126 presently are required to file periodic reports with the Commission under section 15(d) of the Exchange Act. For these companies, the chief additional expense will be in complying with the proxy requirements of the bill, and their costs of compliance will be even smaller than that for covered insurance companies generally.

In opposing the provisions of the bill, representatives of insurance companies have pointed to the possibility of action in the areas covered by the bill by the National Association of Insurance Commissioners, which then presumably would be implemented by the 50 States. The findings of the study show, however, that action is needed now. The study showed that, despite the State requirements of filing of comprehensive public reports, the insurance companies that would be covered by the bill often do not supply adequate financial reports to their shareholders. Also, few, if any, States impose proxy or insider trading requirements of the nature provided by the bill, and the poor proxy practices of insurance companies that would be covered by the bill have been shown. Moreover, the bill would not infringe upon action by the States in the areas covered by the bill. For example, the various States could impose more restrictive rules on insider trading than those contained in the bill. All of the Federal Securities Acts establish nationwide minimum standards, but specifically allow action by the States in the areas covered, limited only by a requirement that such State action not be inconsistent with the Federal statutes and rules thereunder. The bill follows that same pattern. Insurance companies have been included in the overall scheme of disclosure and investor protection provided by the Federal securities laws for 30 years and State regulation has not been prejudiced thereby.

As a final point, it should be noted that insurance companies should be the first to appreciate a primary aim of the bill—to provide investors with adequate information. Insurance companies continuously invest other people's money and rely upon the adequacy and reliability of the disclosures about the companies in which they invest. Investors who invest their own money in insurance companies should be entitled to no less reliable information.

Foreign securities

Securities issued by foreign companies and certificates of deposit issued against such securities would be exempt from the proposed registration requirements for over-the-counter securities. The Commission could terminate the exemption by rule, regulation, or, after notice and opportunity for hearings, by order, only upon findings that a substantial public market in the United States exists for a foreign security or a class or classes of foreign securities and that continued exemption is not in the public interest or consistent with the protection of investors. Thus, interested issuers, broker-dealers, and investors would be afforded adequate opportunity to bring to the Commission's attention all relevant considerations in the public interest.

The securities of Canadian companies have long attracted wide interest in the United States, and, in recent years, there has been a growing interest on the part of U.S. citizens in securities of other foreign issuers, particularly those of Japanese and Western European companies.

Many foreign securities are traded in the United States in the form of American depositary receipts, commonly referred to as ADR's, which are essentially convenient mechanisms for the trading and transfer of underlying shares of foreign issuers. ADR's are created by depositary arrangements made, in most instances, by U.S. banks which issue certificates against deposits of the underlying shares of foreign companies. The certificates are registered in the names of their owners and transferable within the United States in the same manner as a certificate for a domestic security. ADR's provide a convenient method for trading in foreign shares free of many difficulties (such as insurance of certificates in transit and time delays in mailing certificates to a transfer agent in a distant country) involved in transfer and registry of foreign securities. In some situations, an ADR arrangement also will obviate problems arising from capital and currency controls in the country of issue. For the purposes of the securities laws, ADR's are considered a security seperate from the underlying shares and are subject to the registration and prospectus provisions of the Securities Act of 1933. Because ADR's are essentially only a convenient trading and transfer mechanism for shares, the disclosure requirements of the Securities Act are appropriately modified when the ADR's are not issued in connection with registration and public offering of the underlying shares.

The Commission believes that it would be undesirable to apply the provisions of the bill to all foreign issuers on an across-the-board basis. Many foreign issuers have only a few American security holders. To require such a foreign issuer to comply with the provisions of the bill might actually be detrimental to the American security holders, for the expenses involved might be greater than the benefit to them. Moreover, many foreign issuers have no assets or operations in the United States, have never sought funds in the American capital markets, and have never listed a security on an exchange, which factors can make it difficult for the Commission to secure compliance, if the issuer is unwilling to comply. To prevent the securities of such noncomplying issuers from being traded in the United States is no answer, for such a step would seriously and adversely affect American holders of millions of dollars of such foreign securities. These considerations have led the Commission, even in the case of listed securities, to provide an exemption from sections 14 and 16 for foreign issuers, other than North American and Cuban companies.

On the other hand there is no justification whatever for a total and irrevocable exemption of all foreign issuers from the provisions of the bill. Many foreign issuers have significant numbers of security holders resident in the United States and have significant property holdings and operations in the United States. In the case of such foreign issuers it is desirable that the provisions of the bill apply and those provisions can usually be enforced. Moreover, many foreign issuers would be willing voluntarily to comply with the provisions of the bill.

The Commission believes that the provisions of the bill—which provide an exemption for foreign securities and certificates of deposit issued against such securities, and authorize the Commission to terminate the exemption if it finds that a substantial market in the United States exists for such securities—afford the most effective and practical solution to this problem. It takes account of the difficulties of enforcing the provisions of the bill against foreign issuers, provides greater protection to existing trading markets in foreign securities, and permits the Commission to deal flexibly with the application of disclosure requirements in the context of particular issuers or classes of issuers.

It has been suggested that limitations be placed upon the Commission's authority to revoke the exemption. Thus, it has been urged that the bill be amended to provide that, in any event, the exemption not be revoked unless the Commission finds at least 500 registered owners resident in the United States. The Commission does not believe it feasible specifically to limit the application of the registration provisions of new section 12(g)(1) to securities "held of record" by a specified number of residents of the United States. Many foreign securities are issued and held in bearer form. In such cases, stock transfer books showing the names and residence of shareholders are not maintained. A residence requirement would add undue complexities to the administration of the provisions of the bill with respect to foreign securities. It should be noted that domestic companies will be required to register any class of securities held of record by 500 or more shareholders, regardless of whether they are U.S. or foreign residents.

The bill would authorize termination of the exemption for the securities of a class of foreign issuers only if the Commission finds that a substantial market exists for the class as a whole. The Commission would usually proceed on an ad hoc basis. The provision regarding revocation for a class would give the Commission power, where there is an identifiable class of foreign issuers which have equity securities with a substantial public market in the United States, to remove the exemption for the class without having to proceed on a case-by-case basis. An example might be Canadian mining companies with more than a stated number of shareholders resident in the United States and meeting stated standards of trading interest (perhaps as indicated by a number of quotations or a broker-dealer making a market) in the United States.

Should the Commission find that a total exemption is unwarranted for a class or classes of foreign securities, it could still provide a partial exemption for the class or certain securities within the class from one or more of the provisions of the bill and make appropriate modification of other disclosure requirements as it has done with respect to foreign securities listed on national securities exchanges. It has already noted that, except for North American and Cuban companies, foreign securities listed on an exchange have been exempted by Commission rule from the provisions of sections 14 and 16 and from the requirement of filing current and semiannual reports.

Insider trading

Section 8 of the bill would extend the insider-trading provisions of section 16 of the Exchange Act to officers and directors of over-the-counter companies that have securities registered under the new section 12(g)(1) of the act and to the holders of more than 10 percent of any class of such securities. Section 16 is now limited to insiders of listed companies, although the need of investors in over-the-counter securities for protection against the unfair use of inside information, as the Special Study has noted, "may be even greater than that of investors in listed securities. The absence of adequate disclosure by over-the-counter issuers, the lack of data concerning the volume and prices of transactions, and the greater concentration in ownership of over-the-counter securities all combine to create an atmosphere conducive to insider speculation on the basis of information not available to the investing public. Expanded interest in over-the-counter securities, together with the greater volatility in the market for many of these securities in the postwar period, has added to the potential for abuse. The exension of section 16 to the over-the-counter market is necessary to safeguard against the unfair use of inside information and would be an important factor in strengthening investor confidence in the integrity of that market.

Traditional common-law curbs on trading abuses by insiders are inadequate. The safeguards of section 16—disclosure of insiders' securities holdings and transactions, recovery of insiders' short-swing profits (profits from a purchase and sale or sale and purchase within a 6-month period), and proscriptions against short selling and selling against the box—have over the past 29 years demonstrated their effectiveness in respect to listed companies. For these reasons, the bill would extend the protections of section 16 to the over-the-counter market.

The provisions of section 16 do not interfere with an insider's investment transactions. He may buy or sell as much and whenever he pleases, but, because of his fiduciary relationship to the issuer, the section requires him to report his transactions, account for short-swing profits, and refrain from selling his stock short or against the box.

The extent to which the profit-recovery provision discourages insider trading should have little impact upon the market that otherwise exists for the securities covered. The Special Study's data show that during a 10-month period in 1961, 77 percent of all over-the-counter issuers with a class of equity securities held by 500 or more shareholders and with total assets in excess of $1 million, had 200 or more record transfers of their securities and that at least 2 broker-dealers entered wholesale quotations in the sheets of the National Quotation Bureau for 74 percent of these issues. These indications of trading interest suggest that the market for these securities is not dependent upon short-swing trading by insiders.

In connection with previous legislative proposals, the Commission and the securities industry expressed concern over the application of the short-swing profit-recovery provisions of section 16(b) to the transactions of a broker-dealer who is making a market in a security while represented on the issuer's board of directors. The Special Study found that this practice involved a little less than 10 percent of all registered broker-dealers, and an estimated 13 percent of those over-the-counter securities which evoked some trading interest during the 10-month period examined by the study. Frequently, the broker-dealer has been an underwriter for a public offering of the company's securities. It is claimed that because of this prior connection, he necessarily undertakes to make a market in the securities on behalf of his customers. In addition, because of his broad financial experience, he is sometimes sought as a member of the board of directors. If section 16(b) were applied to market-making transactions by such broker-dealer directors, they would be compelled, as a practical matter, to cease their market-making activities or resign their directorships. To avoid requiring them to choose between the two alternatives, the bill would add a new subsection (d) to section 16 to exempt over-the-counter transactions in securities by dealers in the ordinary course of business and incident to the establishment or maintenance of primary or secondary markets for such securities, provided the securities have not been held in the dealer's investment account.

Under new section 16(d), the Commission would have rulemaking power to prescribe the conditions under which securities would be deemed to be held in an investment account and under which transactions would be considered made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market. The Commission also would have power to define each of these terms. This would obviate the necessity of considering applications for exemption on an ad hoc basis, as recommended by the Special Study.

Insofar as these broker-dealer insiders are concerned, the Commission has power to curb by alternative means the misuse of inside information. Analysis of the reports which would be furnished pursuant to subsection 16(a) and the periodic inspections of broker-dealers by the Commission's staff will serve as a deterrent against their misuse of any inside information gained through representation on an issuer's board of directors. Moreover, overreaching by the actual abuse of inside information by a broker-dealer would violate various antifraud provisions of the securities acts and could furnish the basis for revocation of a broker-dealer's registration pursuant to the provisions of section 15(b) of the Exchange Act. For these reasons the Commission believes it appropriate to provide a statutory exemption from the provisions of sections 16 (b) and (c) for market-making transactions of broker-dealers, subject to the Commission's rulemaking power to define terms and conditions for the availability of the exemption.

New section 16(d) would resolve a problem brought to the attention of the Commission by representatives of certain small business investment companies registered under the Investment Company Act of 1940. The securities of many of these companies are traded over the counter, and markets for such securities are sometimes made by a broker-dealer who is also represented on the issuer's board of directors. Since section 30(f) of the Investment Company Act applies the provisions of section 16 of the Exchange Act to the registered closed-end investment companies, the market-making activity of such broker-dealers is now subject to the profit-recovery provisions of section 16(b) and the prohibitions of section 16(c). Transactions incident to such activity would be exempted from these sections by the bill.

Proxy solicitation

Section 14(a) of the Exchange Act now provides the Commission with rulemaking authority concerning the solicitation of proxies, consents, or authorizations in respect of any security registered on any national securities exchange. Section 14(a) would be amended to extend that rulemaking authority to all over-the-counter securities registered under the new section 12(g).

Section 14(b) prohibits members of national securities exchanges and also broker-dealers who conduct business through an exchange member, from giving proxies, consents, and other authorizations with respect to listed securities carried for the account of customers, in contravention of such rules as may be prescribed by the Commission. Section 14(b) would be extended to cover all over-the-counter securities registered under new section 12(g) and all broker-dealers registered with the Commission pursuant to section 15 of the act.

Section 14(b) gives the Commission no power to require broker-dealers to transmit solicitation material to the beneficial owners of securities held in the name of the broker-dealer and to give proxies in accordance with the direction of such owners. Broker-dealers can, therefore, avoid compliance with any rules of the Commission adopted under the existing provisions of section 14(b) simply by not giving proxies at all. To close this gap, the bill would amend existing section 14(b) to empower the Commission to adopt rules under which registered broker-dealers could not refrain from giving proxies with respect to registered securities held by them for the account of customers. Of course, since these proxies would be cast on behalf of the customers, their instructions would be followed in the use of the proxies.

As to listed securities, this problem has been mitigated by rules of the New York Stock Exchange and certain other national securities exchanges which specify the conditions under which members may vote proxies with respect to securities held for their customers and require, upon payment of expenses by the solicitor, the transmission of proxy material to the beneficial owner and the giving of proxies in accordance with the directions of such owner. However, there are no comparable requirements for broker-dealers who are not members of these securities exchanges.

The proposed extension of the provisions of section 14 to registered over-the-counter securities and to all registered broker-dealers makes it important that the Commission have power to adopt uniform rules applying to all broker-dealers with respect to the giving of proxies and the transmittal of proxy solicitation materials with respect to both listed and unlisted securities. A survey by the New York Stock Exchange in 1959 estimated that approximately 8 percent of all securities held by public investors were held in street name by broker-dealers. Any requirements adopted by the Commission with respect to the transmittal of proxy solicitation materials will be conditioned upon the payment of necessary expenses by the issuer or other persons soliciting proxies.

The bill also would amend section 14 by adding a new subsection (c) to require issuers which do not solicit proxies to file with the Commission and transmit to recordholders of their registered securities information substantially equivalent to the information which would be required to be provided in a proxy solicitation. The information would be required to be distributed to shareholders prior to the annual or other meeting of shareholders.

The New York Stock Exchange now requires issuers of securities listed on that exchange to solicit proxies each year. The American Stock Exchange has embarked on a program to achieve the same requirement. However, similar requirements as to listed or over-the-counter securities are not imposed by other exchanges or by any other authority. Because evasion of the disclosures required by the proxy rules is made possible by the simple device of not soliciting proxies, many stockholders are deprived of the material information concerning their company and management which is disclosed in proxy materials. This problem would be accentuated by the extension of the proxy rules, now applicable only to listed securities, to over-the-counter securities, where non-solicitation would occur more frequently because of management's relatively larger holdings. Enactment of this proposal would be a major step in providing shareholders with material information and enabling them to vote upon the basis of a fair presentation of the relevant and material facts.

Material contracts

Sections 3(a) and 4 of the bill would amend sections 12(b) and 13(a) of the Exchange Act to require issuers of registered securities traded in both the exchange and over-the-counter markets to file copies of, and appropriate information with respect to, material contracts not made in the ordinary course of business, in applications for registration or registration statements filed under section 12 of the act and periodic reports filed under section 13. Such contracts entered into after the date of registration would ordinarily be disclosed in and filed as part of the annual report for the year in which such contracts were made, unless the contract, or the circumstances to which it relates, were of such nature as to constitute an event which would call for the filing of a current report.

Disclosure of information regarding material contracts not made in the ordinary course of business is of great importance to investors. Although such information is required to be included in a registration statement filed under the Securities Act of 1933, this disclosure is not now required under the Exchange Act. Copies of the contracts should be filed to provide the Commission with information as to their exact terms, and to enable the Commission to determine more readily whether there has been adequate disclosure.

The Commission's experience under the Securities Act has shown that disclosure requirements for material contracts not made in the ordinary course of business should not be burdensome or difficult. Pursuant to its exemptive and classification powers, the Commission may adopt rules to define and specify the types of contracts which are of material importance to investors. Under section 24(b) of the Exchange Act the Commission has authority to grant confidential treatment when necessary for the protection of corporate secrets. In addition, the furnishing of such contracts by companies having securities registered pursuant to section 12 would make such registration more nearly equivalent to registration under the Securities Act as recommended by the Special Study, and would thus facilitate any effort to integrate these requirements.

Enforcement powers

Section 6(c) of the bill would amend section 15(c) of the Exchange Act by adding a paragraph (4). This would provide the Commission with an appropriate administrative sanction which could be imposed when issuers brought under the bill fail to comply with its provisions. If any person subject to the disclosure requirements of sections 12, 13, or 15(d) of the act fails to comply with those requirements, the Commission could, after notice and opportunity for hearing, publish its findings and issue an order requiring compliance. When circumstances so warrant, the Commission could apply to an appropriate U.S. district court for enforcement of its order.

The Commission believes that this type of sanction is more satisfactory than an authority to suspend indefinitely trading in an over-the-counter security analogous to the delisting procedure provided in section 19(a)(2) of the Exchange Act in respect of securities registered on a national securities exchange. The sanction of delisting for failure to comply with the provisions of the act has been imposed only infrequently by the Commission because delisting would have the effect of relieving the issuer of the duty of complying with the disclosure provisions of the act and would deprive investors of an exchange market for the trading of their securities. With respect to over-the-counter securities, an indefinite suspension of trading would deprive investors of any market for these securities, a result entirely unwarranted by the failure of management to comply with the disclosure requirements of the act. The sanction proposed by the bill would retain the most useful features of delisting proceedings by providing (1) an administrative forum for the resolution of accounting and other complex and technical questions involving disclosure provisions of the act and (2) a means of apprising investors of materially false and misleading filings concerning their securities.

On the other hand a counterpart to section 19(a)(4) of the Exchange Act, which provides for the summary suspension of trading for 10-day periods in securities listed on a national securities exchange, is necessary to prevent fraud in the over-the-counter market. New paragraph (5) of section 15(c) would permit the Commission temporarily to suspend trading when fraudulent or manipulative practices of the issuer or other persons have deprived an over-the-counter security of a fair and orderly market, or when some corporate event has made informed trading impossible and has created conditions in which investors are likely to be deceived. Trading would be allowed to resume as

soon as there has been adequate disclosure and dissemination of the facts material to investment decisions. It is anticipated that this provision will also assist the Commission in its efforts to control the "hot issue" problem.

Section 15(d)

Section 6(d) of the bill would amend section 15(d) of the Exchange Act by eliminating the present coverage criteria for all companies which hereafter file an effective registration statement under the Securities Act. Initially, all such issuers would be required to file reports for the fiscal year during which the registration statement becomes effective, so as to provide a continuing flow of information immediately following the public distribution of their securities. In subsequent fiscal years, a test would be employed to release such companies with less than 300 holders of record of each class of the securities to which the registration statement related from the duty to file reports. This basis for release would also be applicable to companies which are subject to the present provisions of section 15(d). These companies otherwise would not be affected by the proposed amendments.

Section 15(d) now requires that a registration statement filed under the Securities Act must contain an undertaking to comply with the reporting requirements of section 13 if the value of the securities offered plus the value of all other outstanding securities of the same class amounts to $2 million or more. The duty to file is suspended if and so long as the value of shares outstanding is reduced to less than $1 million or the issuer has become subject to an equivalent reporting retirement.

The Commission's experience with these provisions indicates that they frequently create unintended results or operate in a manner inconsistent with the public interest. For example, securities publicly offered sometimes come to be held by a comparatively small number of investors. The duty to file, nevertheless, continues so long as the value of the outstanding securities of the class, even though closely held, exceeds $1 million. Conversely, the value of the outstanding class may drop below $1 million, thus cutting off the reporting obligations even though the securities are held by a very large number of holders, and a significant public interest continues.

Under the proposed revisions, coverage under section 15(d) would terminate upon the same basis as that proposed under section 12(g), thereby eliminating the anomalies that have resulted from the present formula. It would have the effect of applying the reporting—but not the proxy and insider trading provisions—of the Exchange Act to companies which obtain public financing and in which there is a substantial public interest, but which are not large enough to warrant the application at this time, in the light of administrative burdens, of all provisions relating to companies registered under section 12. The cumbersome procedure requiring the execution of undertakings to file reports would be replaced by a direct statutory requirement. The broad exemptive authority of proposed section 12(h) would apply to campanies subject to section 15(d) in order to enable the Commission to adapt and modify the reporting requirements to meet the particular circumstances of different categories of issuers. The application of section 12(h) to section 15(d) would make unnecessary the retention of that exemptive authority now contained in section 15(d).

Unlisted trading privileges

Section 12(f)(3) of the Exchange Act permits a national securities exchange to extend unlisted trading privileges to any security as to which the disclosure requirements and other obligations applicable to the issuer and its management are substantially equivalent to those applicable to listed securities. Application to and approval by the Commission are prerequisites to action by an exchange under this clause. The elimination of the double standard between the over-the-counter and exchange markets would make an estimated 3,900 over-the-counter issuers eligible for such unlisted trading on national securities exchanges. It is considered desirable to repeal section 12(f)(3) to assure that issuers conform to the listing requirements of a registered exchange as a prerequisite to enjoying the privilege of trading on that or other exchanges.

Other amendments of section 12(f) contained in the bill would preserve existing markets for securities now admitted to unlisted trading on exchanges; clarify the Commission's authority to consider all factors pertinent to the public interest in determining whether to extend, suspend, or terminate unlisted trading privileges; and delete certain provisions of existing law which have been, or upon enactment of the bill will become, unnecessary.

Other amendments to the Securities Exchange Act

Section 9 of the bill would amend section 20(c) of the Exchange Act to remove the reference to undertakings, which would no longer be required under subsection 15(d), as proposed to be amended, and to extend the prohibition against interference with the filing of documents, reports, and information to officers, directors, and security holders of any issuer required to make such filings. Section 10 of the bill would repeal section 32(b) of the Exchange Act, which provides for a penalty of $100 a day for failure to file pursuant to un undertaking. The Commission's experience has shown that enforcement of this penalty is not feasible, and as noted above, undertakings would no longer be required under section 15(d) as proposed to be amended.

Amendment to section 4(1) of the Securities Act of 1933

Section 4(1) of the Securities Act of 1933 now requires that dealers deliver a prospectus in all securities transactions occurring within 40 days of the commencement of a distribution of those securities pursuant to the provisions of the Securities Act, whether or not the dealers were engaged in the initial distribution. The proposed amendment is designed to extend the present 40-day requirement to 90 days in the case of the first registered offering by a particular company and to provide the Commission with the power to shorten both the 40- or 90-day periods by rules and regulations or by order.

As indicated in chapter IV of the Report of the Special Study of the Securities Markets, offerings during the years 1959–61 by companies which had not previously offered securities to the public reached the highest level in history. A seemingly insatiable public appetite for certain of these new issues, popularly termed "hot issues," led to rapid rises in the prices of such securities to premiums over the initial offering prices. In this regard the Special Study report concluded that—

"* * * persons who bought in the aftermarket often were less sophisticated and more susceptible to the allure of publicity and rumor about 'hot issues.' These persons, who frequently purchased at premium prices, probably needed the benefits of the information contained in the prospectus more than the original distributees. Yet in many cases they never received a prospectus as required during the first 40 days of the offering." (H. Doc. 95, pt. 1, 88th Cong., (1963), p. 556.)

Ninety days is a more realistic appraisal of the time during which the distribution process continues in the case of many new issues.

Although this proposed amendment of section 4(1), which was recommended by the Special Study, will not provide a cureall for the "hot issues" problem, it will make information available to investors during the course of active solicitation and trading of new issues in the aftermarket and assist in the establishment of more orderly trading in such securities. At the same time, in respect of companies for which a reservoir of public information exists, the Commission would be empowered to shorten either the 40- or 90-day periods, consistent with the protection of investors.

[Attachment]

MEMORANDUM WITH RESPECT TO FRAUD IN THE SALE OF OVER-THE-COUNTER SECURITIES [1]

The primary justification for the extension of the disclosure requirements of the Securities Exchange Act of 1934 to over-the-counter issuers provided by S. 1162 is the need to make available to investors adequate financial and other material information to permit informed investment decisions. The dissemination of this information on a regular and controlled basis to shareholders also will facilitate intelligent judgments as to the stewardship of management. A secondary, but nevertheless important, benefit of the passage of S. 1642 will be its effect as a deterrent and bulwark against fraud.

The availability of reliable sources of current information has been a vital protection to investors in listed securities. It enables responsible broker-dealers and investment advisers to evaluate thoroughly information furnished to them by issuers and other sources. It deprives unscrupulous broker-dealers of the

[1] This memorandum was submitted to the Committee on Banking and Currency of the U.S. Senate during the hearings earlier this year on S. 1642 and is reprinted at pp. 288–307 of the printed hearings before that committee. Although the memorandum speaks in terms of S. 1642, it is of course equally applicable to H.R. 6789 and H.R. 6793.

defense, frequently encountered by the Commission in its enforcement efforts, that any false and misleading information disseminated by them was caused by the failure of the issuer and its management to make adequate and accurate disclosures. Members of the investing public also have an opportunity to protect themselves against fraudulent sales campaigns by checking representations made with the reservoir of information concerning issuers and their securities contained in reports and other documents filed with the Commission and distributed to shareholders. Fraud thrives best where lack of disclosure is most marked.

The overwhelming preponderance of fraud cases before the Commission in past years have involved the securities of companies which have not been subject to the reporting requirements of the Exchange Act. Appendix A to this memorandum contains digests of a representative sampling of these cases. The typical fraud case involves the distribution of securities which are subject to the antifraud provisions of the Securities Act of 1933. Since the majority of these fraudulent distributions involve either new companies or initial public offerings of small companies, the protections afforded by S. 1642 would not have been available. However, in a number of these cases such protection would have been available because of the size of the company involved. There are examples contained in appendix A where S. 1642 would have applied and served to impede continuation of illegal stock promotions. In some cases, management has been deeply implicated in the fraudulent sales of their companies' securities; in other cases, the absence of adequate public disclosure has permitted broker-dealers to perpetrate a fraudulent scheme without the participation by persons associated with the issuer.

Although S. 1642 generally would apply to 35 percent of the issuers actively traded in the over-the-counter market, its effect should be felt in the entire market. The initial application of the disclosure philosophy to trading markets on national securities exchanges has created an appreciation of, and an expectation for, regular and continuous information. For this reason, many over-the-counter companies have determined that confidence can best be maintained by voluntary making adequate disclosures to shareholders. The extension of the disclosure requirements of the Exchange Act to a significant portion of the over-the-counter market undoubtedly will accelerate this trend.

The Commission's experience demonstrates that, in common with other industries, particularly those in promotional stages, distributions of insurance company securities have often been accompanied by fraud, and shareholders in these companies have been subjected to various kinds of management overreaching. State regulation of insurance companies, even when supplemented by State blue-sky laws, has not been an adequate substitute for the protections afforded by the disclosure requirements of the investor-oriented Federal securities laws. Investors in insurance companies stocks traded in the over-the-counter market, like investors generally, need and will benefit by the protections afforded by S. 1642.

Attached as appendix C is a representative sampling of fraud cases before the Commission involving insurance company securities. American Founders Life Insurance Co. furnishes an example of a fraudulent distribution of stock where the insiders distributed their securities at prices higher than the public offering price, while representing that all the proceeds would go to the company. National Union Life Insurance Co. illustrates corporate looting and a fraudulent stock promotion by insiders. National Reserve Life Insurance Co. demonstrates the ability of corporate insiders, in the absence of adequate disclosure requirements, to use their control of the company to solidify that position by the disenfranchisement of public shareholders at great personal profit to themselves.

The requirement of periodic disclosures, in and of itself, often serves as a powerful deterrent against fraud and other abuses. Moreover, the reporting and proxy provisions of the Exchange Act often extend protection to areas which the antifraud provisions of the Federal securities laws do not reach.

Among the cases involving frauds in companies with securities listed on a national securities exchange described in appendix B is the case of *U.S.* v. *Pope*. The defendants in that case diverted over $400,000 of assets from a publicly owned listed corporation, which they controlled, to one of their privately held corporations. The failure to disclose these transactions in proxy statements, as required by the Commission's proxy rules, resulted in their

criminal conviction for violations of these rules and restitution by the defendants of the entire amount diverted. When, as in this case, the diversion of assets does not relate to securities transactions, the Commission has no jurisdiction to prosecute such abuse under the antifraud provisions of section 17 of the Securities Act and section 10 of the Exchange Act.

The Commission's experience demonstrates that the disclosure requirements of the Exchange Act applicable to listed securities have been of considerable assistance in detection, investigation and prosecution of violations of the Federal securities laws. In some instances, the information disclosed in reports filed with the Commission provides the first suggestion of a possible violation of the Federal securities laws. For example in the *Crowell Collier Publishing Co.* case described in appendix B periodic reports filed by the company stated that it had sold $4 million of convertible debentures in reliance on the private offering exemption from the registration requirements of the Securities Act. The staff, after the examination of these reports, initiated an investigation to determine whether, in fact, this examination was available. The investigation subsequently revealed that a block of $3 million of debentures, purportedly sold to 27 persons, was actually sold to 89 purchasers and that further distributions of the common stock into which debentures were converted were made by these original purchasers.

A public distribution of the common stock also resulted from the subsequent sale of an additional $1 million of debentures. Thus, a flagrant violation of the registration requirements of the Securities Act was uncovered simply by routine analysis of reports required to be filed with the Commission.

The disclosure requirements of the Exchange Act are also important when the Commission receives information from a complaint letter or other outside sources as to alleged violations of the securities laws. When this information relates to a reporting company, the ready availability of reports and other required filings with respect to these companies makes evaluation and investigation of the complaint a speedier and more efficient task. Prompt enforcement efforts are essential for the protection of the investing public.

In some instances, unscrupulous managements have sought to conceal fraud and other misconduct by simply ignoring the filing requirements. This is a hazardous course, because the failure to file required reports, when supported by proof of illicit motive, has been sufficient to support a criminal conviction. In the *F. L. Jacobs* case the failure to file reports required under sections 13 and 16 of the Exchange Act led to the downfall of Alexander Guterma, who controlled the company. A Commission investigation initiated because of the delinquency uncovered a large-scale looting of corporate assets, a manipulation of the securities of F. L. Jacobs. This case and Guterma's similar activities in the *Bon Ami* and *United Dye and Chemical Corporations* are described in appendix B.

Frequently, corporate manipulators and fraudulent stock promoters in companies subject to the Commission's disclosure requirements attempt to conceal their activities by filing false information with the Commission. On many occasions, these discrepancies are detected during initial examination of the materials filed with the Commission.

Even when the filing of false information goes undetected during initial examination, further concealment often proves difficult because of the Commission's requirements of continuous disclosure. In some cases significant discrepancies in financial statements filed with the Commission subsequently are discovered by the company's public accountants while engaged in an annual audit for the preparation of reports to be filed with the Commission. Examples of such cases described in appendix B are *H. L. Green & Co.* and *Continental Vending Corp.* In other instances, comparison of information filed with the Commission with the reservoir of information contained in previous reports, proxy solicitation materials, and registration statements by the Commission's staff has disclosed suspicious circumstances, leading to further investigation and the uncovering of abuses by corporate management.

The effectiveness of the Commission's disclosure requirement is vividly demonstrated by the activities of Lowell Birrell, perhaps the most successful corporate marauder of recent times. To conceal his activities, Birrell deliberately chose as his primary vehicle for fraud the Swan Finch Oil Co. Since Ewan Finch securities were admitted to unlisted trading privileges on the American Stock Exchange, the company was not subject to the disclosure

requirements of the Exchange Act. After obtaining control of Swan Finch, Birrell systematically looted the assets of that and other nonreporting companies by a series of complex transactions involving the issuance of Swan Finch and other marketable stocks in exchange for assets of little or no value. He then publicly distributed this stock at great personal profit. The *Swan Finch* case and Birrell's other activities have received wide publicity. A detailed account of these intricate schemes appears in the November 1959 issue of Fortune magazine.

APPENDIX A

Representative sampling of fraud cases before the Commission concerning companies which are not subject to the disclosure requirements of the Securities Exchanges Act of 1934.

AMERICAN EQUITIES CORP.

(See SEC Lit. Rel. No. 1955 (1961).)

American Equities Corp. (formerly Star Midas Mining Corp.) was a corporation dormant for nonpayment of corporate taxes. Reactivated in 1958 to be used as a vehicle for a fraudulent stock promotion. American Equities entered into negotiations to acquire certain properties and businesses. These negotiations never came to fruition. Nevertheless, the properties were treated by the promoters as wholly owned by American Equities. The promoters then had proforma balance sheets prepared which further reflected these misrepresentations. Public interest was generated by the use of the false financials. The promoters then induced the stockholders of Verdi Development Co., a company of which one of them was president, by mailing the stockholders false and misleading proxy solicitations, including the false financials, to approve the merger of Verdi and American Equities. As a result of such solicitation, a favorable vote was obtained, and the merger was consummated. Forty thousand shares of American Equities stock was distributed to the shareholders of Verdi and thereafter found its way into the hands of the general public. The insiders of American Equities received freely marketable Verdi stock for almost worthless American Equities stock. The insiders continued to make use of the false balance sheets in their stock sales campaign. The fraudulent sale of American Equities stock would have been frustrated by either public reports on a current basis including certified financials, or past annual reports. Uncertified and false financials could not have been used as a part of the proxy materials sent to Verdi shareholders had the Commission's proxy rules been applicable.

On March 22, 1961, the Commission obtained a permanent injunction against violations of the registration and antifraud provisions in connection with the above sales campaign, and four of the insiders were convicted of conspiracy and fraudulent activities. They have not been sentenced to date, pending a presentence investigation.

BELMONT OIL CORP.

(See SEC Lit. Rel. No. 1541 (1959).)

Belmont Oil Corp.'s charter had been revoked in 1924 for failure to pay taxes averaging less than $10 per year. It was revived in 1956 solely for the purpose of setting up a stock-selling scheme. The holders of 51,000 shares had defaulted upon an assessment of 5 cents per share on the outstanding stock. The holder of the remaining 299,000 shares undertook to pay the assessment on the total outstanding shares and took title. Subsequently, a promoter acquired the 350,000 shares outstanding and caused to be issued to himself an additional 325,000 shares to be held by himself and his associates. Certificates were issued in various accounts representing the total outstanding shares to nominees.

The corporate name was changed, authorized capitalization was increased 10 times and the total number of outstanding shares increased to 6,750,000 shares. The assets of the corporation were vitually worthless and the corporation operated at a loss.

Shares were acquired by various broker-dealers from the promoter, his nominees and associates, and sold to the public by means of fraudulent representations concerning, among other things, a merger of Belmont with a major oil company, that Belmont owned productive wells and was producing substantial volumes of oil from its operatings, that it had a substantial net worth, that existing stockholders had options to purchase additional shares and that

the shares of Belmont would be listed on a national securities exchange. These shares were sold at varying prices greatly in excess of any possible value.

Had Belmont been required to submit various financial and other reports, such disclosure may have rendered impossible the frauduent distribution of these securities.

Upon complaint by the Commission, an injunction was entered in 1959, halting the fraudulent sale of unregistered common stock of Belmont Oil Corp.

CONTINENTAL SULPHUR & PHOSPHATE CORP.

(See D. F. Bernheimer & Co., Inc., SEA Rel. No. 7000 (1963).)

Continental Sulphur & Phosphate Corp. was organized in 1950 to engage in the sulphur mining and refining business. Continental had always operated at a loss. It had a contract for 50 percent of the first year's production of a sulphur mill which had a capacity of 100 tons per day but never actually produced more than 30 or 40 tons per day or operated profitably.

During the period 1955–59, mostly during 1955–56, D. F. Bernheimer & Co., Inc., a New York broker-dealer, sold more than 600,000 shares of Continental stock to at least 500 persons at prices ranging from 7/16 to 6½. In making these sales, the broker-dealer through its officers and salesmen told customers that Continental owned or would soon own a sulphur-producing plant and that the company, which had 1 million shares outstanding, was earning about $1 per share and was expected to double its earnings and declare a 50-cent dividend. They also mailed sales literature containing references to Continental's "new $1,500,000 mill" and its plans to boost the mill's daily capacity from 100 to 500 tons per day and thereby increase earnings from $1 per share to $5 per share.

The Commission found that these representations were false and misleading, and the broker-dealer was suspended from membership in the National Association of Securities Dealers for a period of 6 months.

If Continental had been subject to the reporting requirements of the Securities Exchange Act, information as to its actual assets and earnings and financial conditions would have been available to the public.

GOB SHOPS OF AMERICA, INC.

(See Bruns, Nordeman & Co., SEA Rel. No. 6540 (1961). See also Gob Shops of America, Inc., 39 SEC 92 (1959).)

Gob Shops, Inc., a retailer of sporting goods and other items, made an initial public offering of its securities in 1955. In 1956 and 1957 its earnings record had been poor, sustaining net losses of $19,000 and $36,000, respectively, for the 9 months ended January 31, 1956, and the fiscal year ended January 31, 1957. A stock dividend paid in December 1956 was charged to capital surplus because of insufficient earned surplus, and published sales figures were misleading because they combined sales by Gob Shops' own stores and by franchised stores which purchased their merchandise from Gob Shops.

Between September 1956 and July 1957, Bruns, Nordeman, a New York Stock Exchange member firm, sold about 134,000 shares of Gob Shops' stock in an intensive telephone sales campaign.

Customers were told that Gob Shops was a successful and growing business which was in sound financial condition, that its stock was a sound investment whose price would rise and would be listed on an exchange, and that a cash dividend would be paid. Representations were made indicating a favorable current and expected sales volume. In addition, customers were told that certain partners of the Bruns firm who were directors of Gob Shops, held appreciable amounts of Gob Shops' stock, and that the firm had a strong position in the stock which it was maintaining. Partners of the Bruns firm, including those who were directors, were in fact, selling their holdings.

Had Exchange Act reporting requirements been applicable at the time of these sales, Gob Shops' reports would have shown the adverse financial information and those reports as well as reports filed under the insider reporting provisions would have reflected sales by the director-partners.

GREAT PLAINS ACCEPTANCE CORP.

(Lit. Rel. No. 2488 (1963))

Certain large shareholders sold their personally owned common stock which they had acquired at 10 cents per share for $2 per share, on the representation that this was company stock and that the proceeds were to be placed in the company treasury for use in operations. In fact, these funds did not go to the company but were pocketed by the sellers.

On January 16, 1963, a permanent injunction on the complaint of the Securities and Exchange Commission was entered against Great Plains Acceptance Corp. and Francis J. Staffes, and a preliminary injunction against others, enjoining them from further violations of section 17(a) of the Securities Act of 1933 in the offer and sale of common and preferred stock of Great Plains Acceptance Corp.

Disclosure of the amounts received by the company from the sale of stock would have been required under the reporting provisions of the Exchange Act.

LONG ISLAND ARENA, INC.

(See John G. Cravin Co., Inc., SEA Rel. No. 6693 (1961); SEA Rel. No. 7064 (1963).)

From August 1960 to July 1961 John G. Cravin Co., Inc., a New York broker-dealer, sold large quantities of the common stock of Long Island Arena, Inc., which owned and operated an outdoor sports arena on Long Island. In making these sales Cravin's salesmen told investors that Long Island was likely to pay dividends, predicted a sharp rise in the price of its stock within the near future, and recommended its securities as an excellent investment. Actually, Long Island's financial condition was poor; it was in no position to pay dividends, and there was no reasonable basis for anticipating that the price of its stock would rise. Never since its organization in 1954 had it earned a profit; it had lost $94,090 during the fiscal year ended August 31, 1960; its earned surplus deficit on that date amounted to $296,628; it was unable to meet its debts as they matured, and mortgages on its properties were in default.

Had the reporting requirements of the Securities Exchange Act of 1934 been applicable to the issuer during 1960 and 1961, it would have been required to file reports with the Commission, which would have been available to the public, showing the adverse financial information. Long Island's gross assets exceeded $1 million and its shares were probably widely held as a result of two public offerings.

The Commission revoked the registration of the above broker-dealer for its activities in the distribution of Long Island Arena, Inc., stock.

MARSHALL MANUFACTURING CO.

(See SEC Lit. Rel. No. 2438 (1962).)

In this case the Commission's investigation showed that 487,500 shares of common stock of Marshall Manufacturing Co. were being distributed in a fraudulent selling campaign. Misrepresentations were made as to the asset value and profitable operation of a California corporation to be acquired by Marshall. The sales agent altered a pro forma balance sheet of the California corporation so that the machinery account was increased from $118,000 to $258,000. This latter figure appeared in the prospectus employed by the sales agent. Investors also were not informed of the insolvent condition of the sales agent and that certain of the machinery of the California company was subject to leaseback agreements.

The Commission obtained an injunction in the United States District Court in Nevada prohibiting further acts and practices violative of the antifraud provisions of the Federal securities laws in the sale of Marshall Manufacturing Co. stock.

NORTHERN BIOCHEMICAL CORP.

(See SEA Lit. Rel. No. 2055 (1961).)

Common stock of Northern Biochemical Corp. (Northern) was offered and sold publicly at varying prices, arbitrarily set by the board of directors. The stock was offered and sold to employees, their friends and relatives, customers of Northern, and others. Northern's feed salesmen sold substantial amounts of the

stock. One year after incorporation the number of authorized shares was increased, and at that time Northern had 281,168 shares outstanding held by 237 shareholders. Three months later there were 374,790 shares outstanding held by 335 persons residing in various States. A minimum of $375,000 was raised through stock sales over the course of several years.

Financial statements of Northern containing false information regarding profits and net worth were distributed at a shareholders meeting, and copies thereof or information contained therein were received by purchasers and prospective purchasers. A similar financial statement was sent to shareholders of Wyoming Oil Co. in an attempt to obtain 80 percent of Wyoming Oil Co. for Northern in exchange for certain assets of Northern. A cash dividend was declared and paid at a time when the company was operating at a substantial loss. The payment of a dividend was represented to purchasers without disclosing that it was in fact a return to capital. Other fraudulent representations concerned refunds of investments and that Northern's earnings warranted several increases in the offering price.

The requirement of filing of accurate financial information with the Commission under appropriate sanction, would appear to have prevented the dissemination of false financial information to Northern's shareholders and purchasers of its common stock.

Investigation of Northern Biochemical Corp. culminated in convictions of the principals for conspiracy to violate and violations of section 5 of the Securities Act of 1933, and fraud.

PONCE DE LEON TROTTING ASSOCIATION, INC.

(See Kay Brunell, doing business as Kay Brunell Securities Co. See SEA Rel. 6913 (1962).)

Ponce de Leon Trotting Association, Inc., owned a harness racing track in northern Florida. As of April 30, 1960, 2,585,000 shares of its stock were outstanding. Following large net operating losses incurred by the company and its predecessor in each fiscal year from 1953 to 1960, the company was placed in receivership on May 4, 1960. As of April 30, 1960, it had an earned surplus deficit of $722,000, current liabilities of $179,000, other indebtedness of $182,000 and no current assets. Beginning in February 1960, the management recognized that it could not conduct a racing season for that year because of lack of capital, and no races were held. Subsequently, the receiver held a public auction of the company's assets and received only a single bid of $50,000.

Despite the precarious financial condition of the company, Kay Brunell, while employed as a saleswoman by another securities dealer, participated in an intensive campaign to sell its stock, representing it to be a safe investment. She predicted a substantial rise in the price of the stock and made statements to the effect that the issuer had sufficient assets to cover the stockholders or investors, that it needed and was raising money to expand its parking facilities, was free of debt, was located in a good spot, had a great potential, and was comparable to the successful Roosevelt and Yonker's Raceways.

The true state of the company's assets and prospect was not available to the public. Investors were deprived of the information necessary to form an investment judgment and had no means to verify the accuracy of the representations made to them.

Kay Brunell's application for registration as a broker-dealer was denied as a result of the above activity.

SPORTS ARENAS (DELAWARE) INC.

(See *Mac Robbins & Co., Inc.*, SEA Rel. Nos. 6462 (Feb. 6, 1961) and 6846 (July 11, 1962).)

Between October 1957 and November 1958, the Mac Robbins firm, while conducting a boiler-room sales campaign, sold over 100,000 shares of Sports stock, at prices ranging from $2 to $7½ per share, by means of numerous fraudulent representations. Sharp increases in the price of the stock and earnings of $1.18 per share were predicted within a short period. Customers were told that the company's earnings were increasing and that it would make a substantial profit, that its stock was expected to be listed on the New York or American Stock Exchanges, and that a credit of about $10 million had been extended to it by a bowling equipment company. Toward the close of the selling campaign the Mac

Robbins firm distributed a brochure which stated that Sports has cash assets of $1,064,861.

Sports, which was organized in September 1957 to own and operate bowling arenas, was in fact losing money and had a net loss of $48,480 for the period ending August 31, 1958. Only one of the salesmen admitted he knew that Sports was "operating in the red"; the other salesmen disclaimed any knowledge of Sports' financial condition.

The filing of reports under the Securities Exchange Act, had they been required, would of course have made the adverse financial information available to the public.

The registration of Mac Robbins & Co., Inc., was revoked by the Commission because of the above activity.

TEXAS-ADAMS OIL CO., INC.

(See *United States* v. *Crosby*, 294 F. 2d 928 (2d Cir., 1961).)

Texas-Adams Oil Co., Inc., is perhaps the classic example of the type of over-the-counter company which should be subject to the reporting requirements of the Securities Exchange Act. From the outset the promoters who acquired control of the company victimized the corporation, stockholders, and purchasers of its securities. Initially they secretly used the assets of Texas-Adams in acquiring control of the company. They then had Texas-Adams acquire a series of companies in exchange for Texas-Adams stock—during the 10-month period after they took control of Texas-Adams, its outstanding stock ballooned from 750,000 to 10 million shares. A typical acquisition involved Texas-Adams issuing its shares for the assets or stock of another company, which were worthless; the Texas-Adams shares would then be "boiler-roomed" out to investors. In many instances shares of the Texas-Adams stock issued in the acquisitions would be "kicked back" to the insiders who would sell them to the public. The court of appeals in upholding the convictions of these promoters described their techniques in *United States* v. *Crosby*, 294 F. 2d 928 (1961) as follows:

"Although the aforementioned dealings were highly effective in keeping a steady flow of Texas-Adams shares entering the market, it was a key to the success of these schemes to maintain the price of those shares at a fairly high level. This was accomplished by a high pressure public relations campaign coupled with the use of patently fraudulent misrepresentations in the company's public reports * * *."

" * * * Later, there was extensive reporting of the empire merger which stressed tremendous growth in the assets of Texas-Adams to a false figure of more than $9 million. In November of 1955, a report to the stockholders was sent to brokers dealing in Texas-Adams. Among major misrepresentations there made were statements that prior to the new management Texas-Adams had a yearly income of $35,000; that acquisition of the Bonanza field in Montana had been accomplished, with resultant additions to income of $33,000 to $34,000 per month; that the new management had acquired, for $300,000 and 850,000 shares of stock, some east Texas oil acreage with $24,000 net monthly income and $4 million proven reserves in each of five well locations; that negotiations had been completed to take over Osage, replete with $300,000 in cash and a producing feldspar mine * * * [and] valuable samples of uranium and mica; and that Homestead when merger, possessed cash totaling $140,000.

"Many of the foregoing—and other—misstatements of fact were made more specifically in a series of Texas-Adams pro forma balance sheets issued with the aid of Herman Lubin, an accountant and coconspirator, in February and March of 1956. What the original report to the stockholders lacked from a purely artistic standpoint was amply supplied by the production and dissemination of an attractive, pictorialized brochure which substantially mimed the bald misstatements of fact and gross overstatements of assets contained in the earlier literature."

Another typical transaction in which Texas-Adams issued its shares was the acquisition of a mining lease from the Osage Mining Co. The actual purchase of the mining lease by Texas-Adams was made in the name of American Montana Corp., which company agreed to resell the mine to Texas-Adams for 650,000 shares plus a cash payment of $75,000. This sale, kickback and resale procedure was used as a vehicle to sell to the public hundreds of thousands of unregistered Texas-Adams shares. The mine in question was inactive, flooded with water and worthless and Texas-Adams never bothered to take title to the lease.

Application of sections 13, 14, and 16 of the Exchange Act to Texas-Adams undoubtedly would have been an inhibition on the type of fraudulent activities engaged in by the defendants. Their short-swing stock transactions would have been subject to the restraints of section 16. Information concerning the acquisitions and stock flotations of Texas-Adams would have been filed with the Commission on a timely basis if the company had been subject to the reporting requirements.

UNITED STATES AUTOMATIC MERCHANDISING CORP.

(See *SEC Report of Special Study of Securities Markets*, H. Doc. 95, pt. 1 at pp. 280–290.)

United States Automatic Merchandising Corp. (USAMCO) was organized in July 1960 to engage in an "entirely new idea in the vending machine business."

Its initial financing was $700,000 in subordinated convertible debentures and a regulation A public offering of 290,000 shares of common stock at $1 per share plus 10,000 shares given to officers making a total of $1 million.

On the day distribution commenced, November 14, 1960, the price was quoted at 3–3½. By April 1961 it had soared to 19⅞. It fell to 15 in June, 9 in September and by October 1961 it was 5 cents bid, 20 cents asked.

At the time of the price rises in USAMCO stock the only available public information consisted of newspaper stories based on the company's press releases and information reported by salesmen of Shearson, Hammill & Co. (Shearson) a New York Stock Exchange firm which made the market and had a large position in the stock. The public was told that USAMCO would earn as much as $1 per share during the first year of operation. In fact, the company never showed a net profit and lost $600,000 through August 1961. Using projected earnings based on contemplated acquisitions which did not materialize, Shearson salesmen predicted that the stock would rise to over $100 per share. By April 1961, the company, according to its president, needed an additional $2 million to operate profitably, and in June its original method of operation was abandoned.

During the period of intensive price activity in USAMCO, officers and employees of Shearson and of U.S. Chemical Milling Corp., and affiliate of USAMCO, held large positions in USAMCO and made large profits by selling while they were recommending that the public purchase.

WOODLAND ELECTRONICS CO., INC.

(See SEA Rel. No. 7016 (1963).)

In 1960 Woodland Electronics Co., Inc., which had been engaged in oil and gas operations, acquired the assets of a company that had developed a machine, known as Speed-O-Fax, designed to transmit a facsimile of documents over telephone lines. Between August 1960 and July 1961 broker-dealer, Alexander Reid & Co. (registrant), sold over 400,000 shares of stock of Woodland at prices ranging from $1 to $1.875 per share to customers, many of whom were obtained as a result of newspaper, television, and radio advertisements which invited requests for information about a low-priced electronics stock. After literature describing Woodland was sent to persons making such requests, one of registrant's salesmen would telephone them and recommend the purchase of the Woodland stock.

Numerous investors later testified as to the representations made to them by registrant's salesmen, including statements that Woodland stock presented a tremendous investment opportuntiy for a customer and could double in price in a short period, and that it would rise like others which had gone up from low prices to $40 and $50 a share.

These representations were not supported by any reasonable basis in fact and were false and misleading. Woodland had never operated at a profit, and had an accumulated deficit of $132,465 at August 31, 1960, and a net loss of $7,200 for the 9 months ending that date; those figures were not disclosed to customers. Up to the time of the sales involved here Woodland had never effected any sale or lease of its machine or entered into any government contracts or contracts with "big" companies, and had not even produced any Speed-O-Fax machines on a commercial basis.

Financial data and other information concerning Woodland's operations were available to the broker-dealer but not to the public. If they had been disclosed in reports filed with the Commission, investors would have had an opportunity to protect themselves against this fraudulent selling operation.

On February 7, 1963, the Commission revoked the broker-dealer registration of Alexander Reid & Co. for willful violations of the antifraud provisions of

the Securities Act and the Exchange Act in the offer and sale of stock of Woodland.

APPENDIX B

Selected fraud cases before the Commission involving companies which have securities listed on a national securities exchange or are subject to reporting requirements pursuant to section 15(d) of the Securities Exchange Act of 1934

BON AMI CORP.

(See SEA Rel. No. 6677 (1961).)

Bon Ami Corp. is a manufacturer of household cleaners with securities listed on the New York Stock Exchange. On May 1, 1956, United Dye & Chemical Corp. (UDY), of which Alexander L. Guterma was then chairman of the board of directors, purchased a controlling interest in Bon Ami for $1,701,000.

On the same day, Guterma caused Bon Ami to purchase $1,250,000 of the debentures of Diversified Oil & Mining Co. (DOM) which was controlled by Guterma and his associates. Bon Ami failed to file any current reports on Form 8–K disclosing the change in control of the company or the fact that the DOM debentures were in fact sold by Bon Ami to a company controlled by Guterma.

During 1957, Bon Ami engaged in a series of transactions designed to acquire approximately $5 million of television time. Bon Ami failed to file any current reports on Form 8–K setting forth the information required concerning this substantial expenditure. In addition, numerous other transactions were either not disclosed as required or disclosed in an incomplete manner.

The failure to file required reports prompted an investigation by the Commission. Subsequently, Bon Ami was delisted by the NYSE; Guterma and some of his associates were indicted and pleaded guilty to charges of defrauding Bon Ami and its stockholders.

COLONIAL SAND & STONE CO.

(See *U.S.* v. *Pope*, 189 F. Supp. 12 (SDNY, 1960).)

Colonial Sand & Stone Co. is a publicly owned corporation with securities listed on the American Stock Exchange. Fortune and Anthony Pope were its controlling shareholders.

The Commission received information that the Pope brothers had diverted the proceeds from an extremely lucrative contract held by Colonial to a corporation wholly owned by them. Since this scheme did not involve transactions in securities, no violations of the antifraud provisions of the Securities Act and of section 10(b) of the Securities Exchange Act could be found. However, the interests of the Pope brothers in these contracts were not disclosed in Colonial's proxy statement filed with the Commission, as required by the Commission's proxy rules.

The Commission's subsequent investigations resulted in the criminal conviction of the Pope brothers for violations of these rules and restitution by them of over $400,000 to Colonial.

CONTINENTAL VENDING MACHINE CORP.

(See REA Rel. No. 7034 (1963).)

Continental Vending Machine Corp., an Indiana corporation with its principal office at Westbury, N.Y., is engaged in the manufacture, sales and servicing of vending machines and has over 5,000 security holders of $4,719,700 principal amount 6 percent convertible subordinated debentures due September 1, 1976, and 4,080,701 shares of common stock. Both of these securities are listed on the American Stock Exchange.

Continental's 1962 fiscal year closed September 30, 1962. Its annual report on Form 10–K for 1962 was due no later than January 28, 1963. It applied for, and was granted, a 30-day extension until February 28, 1963, upon its representation that it had made substantial acquisitions of routes during the last quarter of fiscal 1962, and that there was not sufficient time to enable its auditors to review these transactions. Continental thereafter applied for a further extension, which was denied when Continental's auditors advised the Commission they could not unqualifiedly certify its financial statements because of doubt as to the collectibility of a material receivable. Because certain material facts with respect to the financial condition of the company, including particularly the collectibility of certain loans or advances, were not made public by the company, trading in

its common stock and debentures was suspended by the Commission. According to a statement by the company, approximately 3½ million of collateralized accounts receivable due from a company affiliated with its former president were found to be of little or no value.

On April 8, 1963, a Conservator, appointed by the Federal District Court, was directed, among other things, to prepare and file with the American Stock Exchange and the Securities and Exchange Commission all reports required by section 13 and 15(d) of the Securities Exchange Act of 1934.

CORNUCOPIA GOLD MINES

(SEA Rel. No. 6339 (1960).)

Cornucopia, a mining corporation, was organized in 1930 and registered its common stock on the American Stock Exchange in 1939. It ceased operations in 1941 and remained inactive until 1957 when control was acquired by a group of individuals including Earl Belle.

Belle and his associates sought to use Cornucopia as a vehicle for building a corporate empire and immediately began to acquire the assets of a number of corporations in exchange for Cornucopia stock. To enhance the value of this stock in these transactions and in obtaining bank loans Belle attempted to manipulate trading by buying and selling large amounts of its stock on the American Stock Exchange.

The increased volume in Cornucopia stock attracted the attention of the Exchange. In May 1958, the Exchange, noting that Cornucopia had not filed an annual report for its fiscal year 1957, suspended trading in its stock. The Commission's staff also uncovered a number of apparent discrepancies in Cornucopia's proxy statement for 1958, filed shortly after the suspension of trading. An extensive investigation was commenced by the Commission's staff.

The investigation revealed that the company had not filed current reports with the Commission which required disclosure of the change in control, the company's acquisitions of material assets and the bankruptcy of a subsidiary. The proxy material was replete with material omissions concerning, among other things, the company's operations, financial condition and intercompany transactions, and the 1957 annual report, ultimately filed by the company, contained false financial statements certified by an accountant, who, in fact, had never seen the books and records.

Subsequent action, based on the facts developed during the Commission's investigation, led to the delisting of Cornucopia stock from the American Stock Exchange, the suspension of three accountants from practice before the Commission and the criminal conviction of three of Belle's associates. Belle, however, during the course of the Commission's investigation, fled to Brazil where he remains as a fugitive from justice.

THE CROWELL-COLLIER PUBLISHING CO.

(SEA Rel. No. 3825 (1957))

In this case analysis of the reports required under section 13 of the Exchange Act led to the exposure of a widespread distribution of securities without compliance with the registration requirements of the Securities Act of 1933 by a company in precarious financial condition.

The Crowell-Collier Publishing Co. was engaged for many years in the publication of nationally known magazines and in the publication and sale of books. In 1953 and 1954 the company experienced substantial operating losses and showed only a small operating profit for the first 6 months of 1955. Although it was apparent that additional equity capital was required, the company had concluded that common stock financing would be impossible because of its record of losses.

In July of 1955, the company sold $3 million of 10-year 5-percent convertible debentures in a purportedly private placement to 27 persons including four broker-dealers who executed investment letters disavowing any intention to distribute the debentures. However, the debentures were immediately convertible in common stock at a conversion price of $5 per share which was below the current market price. Thus, purchasers of the debentures could realize an immediate profit upon conversion and resale of the common stock, which was to be listed on the American Stock Exchange. In May 1956, an additional $1 million

of debentures were sold to 22 purchasers including three broker-dealer firms at 160 percent of par.

The company reported the sale and issuance of debentures and the conversion thereof in reports filed with the Commission and the Exchange pursuant to section 13 of the Exchange Act, claiming that the debentures were issued and sold in reliance upon an exemption from the registration provisions of the Securities Act for transactions by an issuer not involving a public offering. A Commission investigation initiated after examination of these reports revealed that this exemption clearly was not available. In the first sale there were, in fact, at least 79 purchasers representing 88 individuals and firms. In the second transaction the three broker-dealers among the original purchasers resold approximately $330,000 principal amount of debentures to at least 15 additional purchasers. Offers were made to an unidentified number of additional persons in both of these transactions. Many of the original purchasers immediately converted the debentures and resold the common stock on the exchange. By the end of June 1956, more thna 93,000 shares of common stock had been issued on conversion and by June 1957, over 250,000 shares had been issued as a result of the conversion.

Through these transactions in debentures and common stock, Crowell-Collier, in the space of 12 months, realized cash proceeds of $4,600,000 and effected a wide public distribution of its debentures and common stock in violation of the registration provisions of the Securities Act. The purchasers were not furnished with the material information that would have been contained in a prospectus and which would have revealed the precarious condition of the issuer's business.

F. L. JACOBS CO.

(See *U.S.* v. *Guterma et al.*, 281 F. 2d 742 (C. 2, 1960).)

In 1956 Alexander Guterma and his associates acquired control of F. L. Jacobs Co., whose stock was listed on the New York Stock Exchange. Thereafter, they set out to loot and divert for their own use the assets of F. L. Jacobs and to use its credit as collateral for loans, the proceeds of which were diverted to Guterma's own use and benefit. Since the transactions did not involve the offer or sale of securities, they were not required to be disclosed by any of the provisions of the Securities Act of 1933. However, the transactions were required to be reported on the company's annual and current reports on forms 10–K and 8–K.

A Commission investigation showed that Guterma and his associates failed to comply with these reporting requirements or to disclose their transactions in F. L. Jacobs' stock, as required by section 16(a) of the act. These efforts to conceal their manipulations and other transactions in the company's securities and their wholesale looting of its assets led to criminal prosecutions. After a 7-week trial Guterma and an associate were convicted of violations of the reporting requirements of the Exchange Act. Both defendants received jail sentences.

H. L. GREEN CO., INC.-THE OLEN CO., INC.

(See SEC Lit. Rel. No. 1361 (1958).)

In 1958, H. L. Green Co., whose securities are listed on the New York Stock Exchange, filed a proxy statement with the Commission. That proxy statement sought approval of a merger of the Olen Co. into H. L. Green. The merger was approved by Green stockholders and consummated. As required by the Commission's rules, the proxy material contained certified financial statements.

In connection with the preparation of H. L. Green's annual report for the year 1959, the certifying accountants detected certain discrepancies in the Olen division's financial statements, which statements had been prepared by the same accountants who had certified the Olen statements that were incorporated in the proxy material. Further investigation revealed that these financial statemens understated Olen's accounts payable by more than $2,700,000, and that the financial statements of the Olen division proposed to be included in the annual report for 1959 would have understated its accounts payable by $2,700,000 and overstated inventories by $3,300,000.

As a result of this investigation, the former president of the Olen Co. was convicted for filing false statements with the Commission.

ULTRASONIC CORP.

(See SEA Rel. No. 3742 (1955).)

A registration statement for Utltrasonic Corp. became effective on June 22, 1954, in connection with a public offering of 200,000 shares of common stock at $12.75 a share, warrants to purchase 89,154 shares of common stock to be offered in exchange for old warrants, and 126,900 additional shares of common stock to be issued upon the exercise of options and conversion of certain outstanding bonds and debentures. The 200,000 shares of common stock were sold by a group of 44 principal underwriters throughout the United States. A large portion of the new warrants were also sold and other shares of the registered common stock were issued upon conversion of the debentures.

The financial statements contained in the registration statement contained an unaudited income staement for the 6-month period ended March 31, 1954, showing a net income for the period of $49,750. At the end of 1954 the company filed a 10–K report for the fiscal year ending September 30, 1954, showing a loss of $3 million for the year. The discrepancy between these financial statements initiated an investigation which revealed that, the profit figures shown in the registration statement for the 6-month period ended March 31, 1954, were, in fact, false and erroneous and that the company should have shown losses of approximately $900,000. As a result of this investigation, the Commission issued a stop order against the registration statement ,and the president of the Company was subsequently convicted of violations of the Securities Act of 1933.

UNITED DYE & CHEMICAL CORP.

(NOTE.—The following article appeared in the Wall Street Journal, Jan. 23, 1963. The five defendants referred to were subsequently convicted and sentenced.)

LONGEST CRIMINAL TRIAL: CASE OF FIVE ACCUSED OF FRAUD IN SALE OF UNITED DYE STOCK NEAR CLIMAX

(By Ed Cony, Staff Reporter of the Wall Street Journal)

A climax is nearing in a stock fraud trial described by Government attorneys as the longest criminal trial in U.S. history.

Lawyers for five defendants, who allegedly defrauded the public with stock of United Dye & Chemical Corp., began their summations in U.S. District Court in New York yesterday, 330 days after the trial began.

The trial got off to a sensational start last March when Gerald Walpin, the assistant U.S. attorney prosecuting the case, charged that the late Senator George Bender (Republican, Ohio) was paid $100,000 while he was an Assistant Secretary of the Interior to "quash an investigation" into the alleged stock fraud conspiracy.

Imprisoned financier Alexander Guterma, listed as a coconspirator but not a defendant, also made headlines in the early days of the trial when he testified that in December 1955 Edward T. McCormick, then president of the American Stock Exchange, was his guest at a Miami hotel when Guterma and two defendants in the case were meeting at the hotel to work out plans to rig the price of United Dye stock. He said, however, Mr. McCormick wasn't present at any of the meetings at which they discussed the proposed manipulation. United Dye at the time was listed on the New York Exchange.

NINE PLEADED GUILTY

In the 11 months since the trial began, 9 of the 16 original defendants have pleaded guilty to one or more of the 30 counts returned by a Federal grand jury, a 10th defendant has pleaded no contest, and an 11th has suffered a heart attack and been severed from the case. The remaining five defendants continue to profess their innocence.

What is the Government's case about?

Prosecutor Walpin has told the jury this story: The 16 defendants entered into a conspiracy, or "criminal partnership," to sell shares of United Dye to the public without giving the information about the stock required by the law. They avoided giving this information by failing to file with the Securities and Exchange Commission a registration statement covering the stock. They pro-

ceeded "to lie to and misinform the public" about this unregistered stock, selling it by high-pressure, or "boiler room" tactics, the prosecutor charged. And, while they were selling it, they manipulated the market "to keep the price up illegally," the jury was told.

The scheme hardly could have worked better, according to the Government. In all, the group managed "to sell to the duped public" over 400,000 shares of United Dye at a price of over $5 million, the Government says. After the group had unloaded these shares, the price of United Dye nosedived, and many of the unsuspecting buyers sold the stock at less than one-tenth what they'd paid for it, the prosecution states.

In identifying the various defendants and alleged coconspirators in the complex case, Mr. Walpin divided them into four separate groups. The "Eastern group" consists of certain former top officials of United Dye. Among them: Guterma, former chairman, and Virgil Dardi, former president and one of the five defendants who haven't changed their pleas to guilty.

In Mr. Walpin's "Western group" are two of the kingpins in the alleged conspiracy, both of whom have pleaded guilty since the trial began. They are Samuel Garfield and Irving Pasternak, identified as "partners in the oil business." Garfield and Pasternak are both known to be associated with individuals active in Nevada's legalized gambling industry.

THE "LAS VEGAS" GROUP

In fact, the term "Western group" appears to be a euphemism for "the Las Vegas group." A third member of this group, according to Mr. Walpin, is Allard Roen, described in the indictment as a major owner of two Las Vegas hotels. In Nevada records, Mr. Roen is listed as executive vice president of United Resort Hotels Corp., which operates the Stardust, and the Desert Inn, two luxurious gambling hotels in Las Vegas. He also appears in Nevada records as secretary-treasurer of Karat, Inc., which operates the gambling casino at the Stardust. Mr. Roen, who is described by the Government in its United Dye case as "a protege and partner" of Garfield and Pasternak, has pleaded guilty to the conspiracy charge.

Mr. Walpin's third grouping consists of seven brokerage firms and their principal owners. He labeled this group "the boiler rooms." His fourth and final category: "the manipulators." These are people he said bought and sold stock in order to rig the market.

With his large cast of defendants and alleged coconspirators categorized, Mr. Walpin proceeded to outline to the jury what he hoped to prove.

His contentions follow:

There were six steps in the successful scheme. First, Guterma and his two principal partners, Garfield and Pasternak, gained control of United Dye. In the summer of 1955, Guterma bought 38,500 of United Dye's total of 150,000 common shares at $10 a share from Lowell Birrell, who is currently a fugitive in Brazil. Mr. Dardi set up this opportunity for Guterma to gain effective control of United Dye, and was guaranteed a percentage of the profit for his pains, the Government maintains.

"AVOIDED CASH OUTLAY"

At about the same time, acting in concert with Guterma, Garfield and Pasternak acquired Franklin County Coal Corp. "from the Murchisons of Texas, who were very happy to sell (it) to the conspirators." The price was $519,000; but, by giving the Murchisons a promissory note, the conspirators avoided any immediate cash outlay, the Government charges. Franklin County Coal had a pipeline and a coal mine "that had not been mined in years," and not much else in the way of assets. But the conspirators figured it looked attractive enough to anyone not thoroughly familiar with the company to help them in their complicated plan, according to the Government.

Their ultimate object, so the Government says, was to cause United Dye to issue more stock—and to get their hands on the additional United Dye shares. Franklin County Coal was to play a vital role in accomplishing this.

In Mr. Walpin's account, step three was taken when Franklin County Coal was put into a corporate shell called Handridge Oil, which was owned by Garfield and Pasternak. Once they breathed a little life into Handridge, via the acquisition of Franklin County Coal, according to the Government's charges,

the conspirators were ready for step four: They had United Dye acquire Handridge and pay them by issuing 575,000 shares of United Dye as the merger price. Thus, the conspirators got the stock they wanted in what seemed to the casual observer to be a legitimate transaction.

But what had actually resulted was that they had acquired United Dye stock worth over $5 million at market prices then prevailing in return for a noncash outlay of only $519,000 according to the Government.

Step five consisted of selling most of these 575,000 shares through "over-the-counter boilerrooms," Mr. Walpin said. While they sold those shares to the public, the defendants allegedly engaged in step six: They allegedly rigged the market on the New York Stock Exchange to prevent the price of United Dye stock from falling before they could unload their big block of stock via the boilerrooms, the Government maintains. To do this they bought United Dye stock on the exchange at the same time they were selling much larger quantities over the counter, according to the prosecution.

The five defendants who haven't pleaded guilty don't agree, of course, with this version of Mr. Walpin's as to what happened. Besides Mr. Dardi, they are Charles M. Berman, Robert B. Gravis, Charles Rosenthal—all of whom are being charged by the Government with being principals in boilerrooms that distributed United Dye stock—and R. B. Gravis, Inc., one of the alleged boilerrooms.

GUTERMA TESTIMONY DISPUTED

Yesterday, Mr. Berman, who in serving as his own counsel, characterized Guterma as the Government's chief witness against him, and he tried to discredit Guterma's testimony: "This man is in jail. He wants to get out of jail. He told the story the Government wanted to hear."

Mr. Berman was an owner of G. F. Rothschild & Co., one of the brokerage houses Mr. Walpin cited in his list of "boiler rooms" that sold United Dye stock. Denying that he or his firm ever used any "high pressure methods" to sell United Dye stock, Mr. Berman yesterday said the Government had failed to produce any witness who testified he gave Rothschild Salesmen any "improper instructions" concerning the sale of United Dye stock. Of brokers making phone calls to sell stock, he said: "There's nothing wrong or indecent with urging people to buy a stock listed on the New York Stock Exchange."

Philip Samuels, atorney for Mr. Gravis and R. B. Gravis, Inc., also attacked the credibility of Guterma and two other witnesses he said the Government relied on to substantiate its conspiracy charge against his clients. He characterized them as "three pitiful witnesses, three admitted perjurers," and he said there were "discrepancies in the testimony they gave here."

APPENDIX C

Representative sampling of fraud cases before the Commission concerning insurance companies securities traded in the over-the-couter market

NATIONAL UNION LIFE INSURANCE CO.

(SEC Lit. Rels. 1204, 2058 (1961))

National Union Life Insurance Co. was organized under the laws of the State of Alabama in 1949. In 1953 it moved its home offices to Miami, Fla. It has assets of approximately $3 million, and 2,350 stockholders. In 1955, at the request of the State of Alabama, the company relocated its home offices to Montgomery, Ala. During the period of operations in Florida, the company was the subject of an investigation of the Dade County grand jury, which investigation led to the indictment of several of its officers for participation in a fraudulent scheme in the sale of National's stock.

Several techniques were used in furtherance of the scheme. National's stock was purchased on the market at prices of from $2 to $40, and resold at from $5 to $63.50. Since the supply of stock was limited, the corporate insiders who engineered this fraud caused the company to issue 10,000 shares of stock, purportedly for the purchase of an office building. Rather than going to the vendor of this building, the stock was acquired by one of the insiders. The purpose of this transaction was to defeat the preemptive rights of existing shareholders of the company. In addition, the insiders caused the company to issue 5,000 shares

of stock to be exchanged for certain mortgages. In fact, the mortgages were never received by the company, and the stock was acquired by the insiders for resale. Having guaranteed themselves a supply of stock, these same insiders then manipulated the market by engaging in transactions among themselves and others: by arbitrarily raising the price of the stock with the collusion of broker-dealers; by causing the company to declare a 25-percent stock dividend, which they knew could not be paid; and by publishing and distributing false and fraudulent information about the company, including misinformation about the Company's earnings, management, and financial condition.

A regulation A filing made with the SEC regional office in Atlanta brought this case to attention of the Commission when its examination disclosed irregularities in the company's financial statements, and its description of the aforementioned transactions.

In July 1961 convictions were obtained against the defendants in the criminal case, and they were fined a total of $15,000.

National Union is not a reporting company, but would be, under the standards of S. 1642. Had it been reporting at the time of the fraudulent distributions, compliance with sections 13, 14, and 16 would not only have caused the disclosure of the insider transactions, or a false filing, but would have provided such current accurate financial information as would have made the falsity of these representations apparent to investors.

AMERICAN FOUNDERS LIFE INSURANCE CO.

(SEC Lit. Rels. 1254 and 1278 (1958); 1482, 1527, and 1681 (1959); 2005 (1961))

The American Founders Life Insurance Co. of Denver, Colorado ("AFL") is a Colorado corporation organized in October 1955 with an unthorized capital stock of 2 million shares. Within a few months of its organization, 1 million shares of the company were sold to the public at a price of $2 per share by an underwriter under the control of the management of AFL. The shares were sold in reliance upon the availability of the intrastate exemption.

The remaining 1 million shares of authorized stock were issued to a group of insiders in exchange for notes collateralized by the stock issued to the insiders. Following completion of the public offering, the insiders began to sell large blocks of their shares to the public at prices of $2, $4, and $6 per share. These sales continued through 1958. Purchasers were advised that the proceeds of their purchases would be received by AFL, but those who paid $4 and $6 per share were not told that AFL would issue the shares to the insiders at the rate of $2 per share and that the excess paid by the public would inure to its insiders.

During the course of the distribution of the insiders' stock, numerous misrepresentations were made concerning, among other things, the financial condition of AFL, the market price of the securities, the use to be made of the proceeds of the sale of securities, the interest of the insiders in the securities of the issuer and in organizaitons which had contractual arrangements with the issuer, the financial success of other securities, and the profits that would have been made by investors in these securities. In 1956 the company stated that it had several thousand shareholders and represented that it had assets of over $3.5 million. Registration of the securities of this company would have been required by the provisions of proposed section 12(g) at least by the end of its fiscal year in 1956. The attention of the Commission was focused on this case by an attorney representing a group of defrauded stockholders.

In 1959 the Commission secured a permanent injunction against the company, its officers, directors, employees, and agents for violations of the registration and antifraud provisions of the Securities Act of 1933. Subsequently, permanent injunctions were also obtained against certain of the individual officers and directors of the company.

NATIONAL RESERVE LIFE INSURANCE CO.

(SEC Lit Rel. 2450 (1962))

National Reserve Life Insurance Co. was organized in 1921, and the present company resulted from a merger between National Reserve and another company in 1951. As of December 31, 1962, National Reserve had assets totaling $81,701,587.67 and its shareholders numbered about 5,340. In 1961 the management caused the company to make two exchange offers with the stockholders of Na-

tional. They also caused the company, by means of its profit-sharing pension trust, to purchase scrip from the stockholders at far below the market value of that scrip. The effect of these three transactions was to solidify the voting control of existing management to the financial detriment of National's stockholders. In June of 1961, the company offered to exchange 3,000 shares of its nonvoting preferred stock to its then holders of 42,000 shares of voting common stock. All of such 3,000 preferred shares were taken up by the holders of 3,000 shares of the common stock. In December of 1961, the company offered to exchange 10,000 shares of nonvoting preferred stock with the holders of 39,000 shares of voting common stock on a share-for-share basis. Of the preferred stock 2,820 shares were taken up by the holders of 2,820 shares of the common. The shareholders of the company were not informed by the company of the true value of the common stock they held and the company represented in its dealings with the shareholders that the exchange was executed at a fair value. A check of the over-the-counter market as to the common stock of National indicated that the common stock was selling for approximately $200 per share at the time of the first exchange and $300 at the time of the second exchange. There were some differences between the preferred stock offered in the two exchanges, but the maximum value of the preferred was in each case about one-half that of the common. Both in June and December of 1961 there were four broker-dealers making an active market in National's common.

Commencing on August 21, 1961, the company acquired from other stockholders, at a price of $70 per full share, an aggregate of about 930 shares of common stock through purchase of stock scrip resulting from the exchanges. During the time the stock scrip was being acquired from stockholders at a price of $70 per full share, the stock had an active market range of between $170 and $310 per share.

The case was brought to the attention of the SEC by an anonymous person, who, on June 7, 1961, submitted to the headquarters office in Washington, D.C., a form letter of National Reserve Life Insurance Co., dated June 7, 1961, describing the exchange offer.

On December 10, 1962, the company and its officers and employees were permanently enjoined from further violations of the antifraud provisions of the Federal Securities Acts pursuant to a decree. On March 29, 1963, the company filed a registration statement, including an offer of rescission to those shareholders who had participated in the exchange. National would clearly fall within the scope of S. 1642, but at present is not a reporting company. Its only previous filing with the Commission was a 1955 Regulation A offering for approximately 14,000 shares of its common. Both exchange offers were pursuant to charter amendments and involved the creation of new classes of stock and were therefore matters which would have been "8–K events" and thus reportable were this company subject to the reporting requirements of section 13.

CARDINAL LIFE INSURANCE CO.

(SEC Lit. Rel. 2057 (1961))

In 1957 Charles C. Bales and certain of his associates and a broker-dealer who were later convicted criminally exercised options to purchase Cardinal stock at 5 and caused the original issue stock to be issued and delivered to the public at prices ranging from about 10½ to 13. Buckley then paid $5 per share (the option price) to Cardinal, took his 15-percent commission and remitted the balance to the other persons. Approximately 71,000 shares of their option stock was sold in this manner by false representations and omission of the statement of certain material facts.

These persons further defrauded investors by advancing a portion of their profits to a fund for the purpose of purchasing available Cardinal stock in the over-the-counter market. This resulted in maintaining and raising the quoted market price of the stock during the time the said option stock was being sold to the public.

This case came to the attention of the SEC through the investigation conducted on the Foundation Life Insurance Co. in which some of the same individuals were involved.

The number of shareholders was 1,100 or more in 1960. Assets in 1960 were about $2 million.

Section 16(a) of the Securities Exchange Act of 1934 would have required these transactions to be reported if it had applied. Not only would investors

have been better informed of this situation, but the participants would have been deterred because of the requirements of section 16(a) and of the attendant consequences under 16(b).

The defendants were convicted of violating the antifraud provisions of the Securities Exchange Act.

ESTATES LIFE OF WASHINGTON

(Lit. Rel. 2045, 2319 (1962))

Defendants were convicted and given jail sentences in July 1962 of, among other things, violations of the antifraud provisions of the 1933 act in connection with the offer and sale of stock of Estates Life of Washington.

The fraud involved false representations and concealment of material facts concerning, among other things: the extent to which officers had invested in such stock; the amount of insurance ready to be placed on the corporation's books; the future value of such stock: misuse of proceeds from such sales; false information provided the SEC about such offering; issuance of stock without payment; and falsification of the corporation's books and records. In addition, defendants used a conduit organization by which they obtained from Estates Life $122,000 which they used for their personal benefit.

Reports filed under the 1934 act would have disclosed to the Commission and to the investing public the financial condition of the company, the insider transactions, insider interests in material transactions with the company, and other important information.

FARM AND HOME AGENCY, INC.

(Lit. Rel. Nos. 1549, 1414, 1261 (1958, 1959))

On April 16, 1958, a final decree was entered in the U.S. District Court for the Southern District of Indiana permanently enjoining the company, Philip H. Meade, its president, Chester R. Koza, its secretary, E. Bernie Shelton, its vice president, and W. Harold Hilbert, a broker-dealer, from violating sections 5(a) and 5(c) of the Securities Act of 1933 in the offer and sale of the company's common stock. On December 18, 1959, in the U.S. District Court for the Southern District of Indiana, verdicts of guilty were returned on a criminal indictment charging Meade, Shelton and Hilbert with willful violation of the registration provisions of the Securities Act of 1933. All three defendants received 2-year prison sentences, but execution of the sentences was suspended and the three convicted defendants were placed on probation. In addition, Meade and Shelton were each fined $10,000 and Hilbert received a fine of $7,500.

The defendants willfully violated the registration requirements of the Securities Act of 1933 by offering and selling Farm and Home Agency, Inc. stock without a registration statement with respect to such securities being on file with the Commission. The defendants sold the stock to nonresidents of the State of Indiana, thus destroying their claim to an intrastate exemption from the registration requirements, and conspired to conceal the true identities of the purchasers of such securities and to create the appearance of sales to residents of the State of Indiana by the use of dummies and nominees.

The case was opened as the result of a routine inspection of a broker-dealer's books by the Chicago regional office. The Chicago regional office noted that the broker-dealer had sold approximately 25,000 unregistered shares of the capital stock of Farm and Home Agency, Inc.

The name of the company has been changed to Farm & Home Insurance Co. As of January 1, 1962, its assets amounted to $1,937,560. The company was not subject to the reporting requirements of the SEC. Proper and truthful form 8–K reports would have resulted in earlier detection of the violations and the necessity for such filings might have deterred the violations themselves.

Item 7 of form 8–K under section 13 of the Securities Exchange Act of 1934 requires the reporting of any increase in the amount of securities outstanding, a statement as to whether or not such securities were registered under the Securities Act of 1933; if not, an indication of the exemption claimed and the facts relied upon to make the exemption available.

LIFE INSURANCE CO. OF KENTUCKY

This was another promotion by Charles C. Bales and associates. In issuing a prospectus for the sale of stock, disclosure was required that Bales, a promoter, and the president, Mr. Hensley, had both been convicted in connection with the Cardinal Insurance Co. case.

The prospectus also disclosed the following facts:

The company was organized in 1956. In 1957 the entire stock of the company was distributed to the shareholders of the Kentucky Industries Trust Co., Inc. which was the promoter of the company.

(1) Charles C. Bales and Robert B. Hensley (president of the company) were promoters of the Kentucky Industries Trust Co. and in effect obtained 60 percent of its shares at no cost and sold the other 40 percent to the public for $300,000.

(2) In early 1958 Mr. Bales and Mr. Hensley sold 35,000 shares of the company's stock to Kentucky Industries Trust at a price of $2 per share.

(3) In March 1960 the company purchased 90,000 shares of its stock from Mr. Bales at a price of $5.55 per share with an apparent profit to Mr. Bales of $495,050. Due partially to this purchase the company had a deficit in its surplus account.

(4) In non-arms-length contracts made with two corporations promoted and controlled by Charles C. Bales, the company made substantial payments to these corporations for organization efforts, administrative and sales services. Until these contracts were settled and terminated Mr. Bales was consulted with respect to important affairs of the company. Amounts paid out through June 30, 1962, totaled over $800,000.

(5) Mr. Robert B. Hensley, president, received net commissions of approximately $89,000 on the sale of Kentucky Industries Trust stock mentioned in (1) above. He also, as general agent of the company from 1957 to 1959, has received commissions of over $500,000 through June 30, 1962, and is expected to receive a further $736,000.

(6) Mr. Bales and Mr. Hensley were both convicted of violating the antifraud provisions of the Securities Exchange Act in the Cardinal Insurance Co. case.

This case came to the attention of the SEC in 1962 by reason of the actions which had taken place in the Cardinal Life Insurance Co. and the Foundation Life Insurance Co.

The Life Insurance Co. of Kentucky has over $9 million in admitted assets. The number of stockholders is 4,300 and the stock is publicly traded in the over-the-counter market.

This company has not filed any reports with the SEC under the Securities Exchange Act of 1934, section 15(d), as a result of its registration. Certainly such reports would be of value to anyone wishing to purchase stock in the company as the facts reviewed above would then be disclosed.

LIFE UNDERWRITERS INSURANCE CO.

(SEC Lit. Rel. 1932 and 1941 (1961))

On March 10, 1951, Decker-Thompson, Brokers, Inc., an unregistered broker and dealer; Arthur C. Decker, Jr., its president; and Harold Bernard Thompson, its vice president, were permanently enjoined from further violating the registration and antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 in connection with the offer and sale of shares of capital stock in Life Underwriters Insurance Co. The defendants consented to the entry of the decree.

Subsequently, on April 26, 1963, the broker-dealer registrations of Decker and Thompson were revoked by this Commission.

Decker-Thompson, Brokers, Inc., while selling the common stock of Life Underwriters Insurance Co., failed to disclose to purchasers that it, as well as Life Underwriters Insurance Co., is controlled by defendant, Arthur C. Decker, Jr.

The complaint also alleged that Decker-Thompson, Brokers, Inc., and Harold Bernard Thompson and Arthur C. Decker, sold common stock of Life Underwriters Insurance Co. owned by them at the price of $10 per share, upon the false representation that they could not sell such stock at a lower price because it was a part of an issue which had been registered with the Securities and Exchange Commission for sale at the price of $10 per share.

The case was opened on October 30, 1939, after a routine broker-dealer inspection disclosed that Decker was both principal underwriter and controlling shareholder of the company.

As of January 1, 1962, the company's total assets amounted to $1,424,985. Its securities are not listed in the over-the-counter pink sheets.

Having filed a registration statement with the Commission, the company did undertake to file those reports required to be filed by section 15D of the Securities Exchange Act of 1934. It is not subject, however, to the reporting requirements of section 16 of said act.

If the insurance company had been subject to the provision of section 16 of the Securities Exchange Act of 1934, insider reports filed by the defendants would have disclosed their positions and transactions.

PACIFIC-ATLANTIC LIFE INSURANCE COMPANY

(SEC Lit. Rel. No. 2615 (1963))

Certain persons organized Pacific-Atlantic Life Insurance Co., and caused it to issue options to national underwriters to purchase approximately 75,000 shares of Pacific-Atlantic Life Insurance Co. stock. A large portion of these options were represented by stock option certificates. Thereafter, these persons sold the certificates by false and misleading statements that the life insurance company was doing very well, it was going to start selling insurance in Idaho, and that the securities would double in value in the near future.

Among other things, the defendants omitted to disclose to investors that Pacific-Atlantic Life Insurance Co. had never operated profitably and that the stock option certificates required an additional exercise payment of $5 per share before any stock could be obtained.

If reports had been filed with the Commission pursuant to the proposed legislation, investors would have an opportunity to learn of the operating results of the company and the terms for exercise of the stock option certificates, material facts falsely represented or concealed.

On May 2, 1963, the U.S. District Court for the District of Wyoming entered an order permanently enjoining American Brokerage Co. and others from further violating the antifraud provisions of the Securities Act of 1933 in the offer and sale of stock option certificates of Pacific-Atlantic Life Insurance Co., or any other securities.

UNITY INSURANCE COMPANY OF OMAHA

(SEC Lit. Rel. 1430 (1959) and 1729 (1960))

Unity Insurance Co. was organized in 1956 as part of a fraudulent stock promotion scheme. The company is now defunct. The promoters of the company made numerous false and misleading statements in the sale of its stock. They represented that purchasers of the stock might have their money back at any time; that the money raised from the sale of the stock would be placed in escrow until the license or franchise to go into the insurance business was issued by the State of Nebraska; that the stock was going to rise in price; that the company had the money to qualify and get its insurance license; that the company was doing so well they would refund the money to the purchasers at any time at 5 percent interest; and that certain persons had made substantial investments in the Unity Insurance Co. They failed to disclose that the principal organizers, officers, and directors of the Unity Insurance Co. would not invest any of their own money in the company and that the stock purchased by the investors was stock optioned to an officer or director and that the greater portion of the purchase price would be retained by the officer or director making the sale.

The Commission's investigation was initiated on the information given by the U.S. attorney for the District of Nebraska who received complaints of fraudulent representations in the offer of the Unity stock. As a result of this investigation, three of the promoters were convicted and sentenced for violations of the antifraud provisions of the Securities Act of 1933.

Mr. HARRIS. We have another statement dated November 19 of the Commission with respect to the proposed amendments to sections 15(a), 15(b), and 15A of the Securities Act of 1934.

I might say the other one was not only to the Securities Exchange Act of 1934, but the Securities Act of 1933.

Is this also a supplement or is this a restatement of what you have in the previous supplement that you have included?

Mr. CARY. I would like to ask Mr. Fleischer to speak to that, Mr. Chairman.

Mr. FLEISCHER. Mr. Chairman, some of the material in this justification statement has been incorporated in the chairman's statement which he read. But it also has additional material in it which is not reflected in that statement.

Mr. HARRIS. Which supplemental statement are you talking about?

Mr. FLEISCHER. With respect to the proposed amendments of 15(a), 15(b), and 15A, dated November 19.

Mr. HARRIS. I would suggest that they be received, Mr. Chairman, for the record, if on review it is deemed that they should be included in the record, and if not, for file. There is no use putting duplicating information into the record.

Mr. CARY. Mr. Chairman, we will check this and if there is anything that is duplication, we will see that it is eliminated and only add that part which is a true supplement.

(The material to be furnished follows:)

STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION WITH RESPECT TO THE PROPOSED AMENDMENTS TO SECTIONS 15(a), 15(b), AND 15A OF THE SECURITIES ACT OF 1934

These proposed amendments, contained in sections 2, 6(a), 6(b), and 7 of the bill,[1] would strengthen the standards of entrance into the securities business, enlarge the scope of self-regulation, refine and improve Commission disciplinary controls over brokers, dealers, and their employees, and clarify and improve existing provisions dealing with related matters. Nearly all of the proposed amendments are based upon recommendations of the Special Study of Securities Markets.

A short outline of the present law may facilitate understanding of the proposed amendments. Subsections (a) and (b) of section 15 of the Securities Exchange Act require brokers and dealers doing business otherwise than on an exchange to register with the Commission and provide for revocation or denial of registration, if the firm, or any person associated with it, has been convicted of crimes involving securities transactions or the securities business, is enjoined from engaging in any act or practice in connection with securities transactions, or has willfully violated the Securities Act of 1933 or the Securities Exchange Act of 1934.

Section 15A of the Securities Exchange Act provides for the registration with the Commission of national securities associations, which are organizations of over-the-counter brokers and dealers established primarily for the purpose of providing, in the over-the-counter market, a medium for self-regulation comparable to the securities exchanges in the listed market. Section 15A contains rather detailed provisions concerning the rules, organization and disciplinary proceedings of such associations and gives the Commission a certain amount of regulatory power over such associations. At present, only one such association, the National Association of Securities Dealers, Inc. (the "NASD"), is registered.

In summary, the principal proposed changes in existing law are as follows:

1. All over-the-counter broker or dealer firms woulld be required to be members of a registered securities association.

2. Registered securities associations would be required to adopt rules establishing standards of training, experience, competence, and other qualifications for members and persons associated with members and to establish capital requirements for members.

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[1] Secs. 2, 6(a), 6(b), and 7 of the 3 pending bills are virtually identical in all important respects, and references herein to "the bill" refer to any one of the 3. The areas in which there are differences of substance are pointed out in the technical statement.

3. The Commission would be empowered, in disciplinary proceedings, to proceed directly against an individual associated with a broker or dealer in lieu of proceeding against the entire firm, and the authority of a national securities association to do the same would be clarified.

4. In disciplinary proceedings against a firm, the Commission would be expressly empowered to impose the lesser sanctions of temporary suspension of registration for up to 12 months or censure, if it concludes that the drastic step of revoking registration is not warranted.

5. The Commission's powers to require alteration or supplementation of the rules of a registered securities association relating to organization, discipline, and eligibility for membership would be broadened.

6. Certain other changes would be made, including:

(*a*) A slight broadening of the category of crimes, injunctions, acts, and omissions that afford a basis for disciplinary proceedings by the Commission, including the addition of willfully aiding and abetting in violations, or failure reasonably to supervise employees and others who violate, as another basis for such proceeding;

(*b*) Eliminating, in the case of registered brokers and dealers, the necessity for proving that the mails or instrumentalities of interstate or foreign commerce were used in a particular proscribed transaction;

(*c*) Eliminating the exemption from registration for brokers or dealers whose business is "exclusively intrastate" but who use the mails or any means or instrumentalities of interstate or foreign commerce;

(*d*) Shortening the period for appeals to the Commission from action taken by a registered securities association from 60 to 30 days;

(*e*) Giving the Commission the power to lift a stay of action taken by a registered securities association while the appeal is pending before the Commission, if the Commission finds that the public interest or the protection of investors requires such action;

(*f*) Requiring a registered securities association to have rules relating to quotations of securities sold other than on an exchange, which rules shall be designed to produce fair and informative quotations; and

(*g*) The making of certain other clarifying changes in existing law.

These proposed amendments are discussed in more detail below.

Requirement of membership in a self-regulatory body

A significant part of the regulation of the securities markets provided in the Securities Exchange Act is based upon the concept of self-regulation by industry organizations, under the supervision of the Commission. This philosophy was notably reaffirmed in 1938, when Congress enacted section 15A of the act. This extensive reliance on self-regulation rests on two principal premises; first, it provides an alternative to a much more pervasive direct regulation by the Government, which would be expensive to the taxpayers and burdensome to the industry, and it also provides a more sensitive and effective device for regulation in the area of unethical as distinct from illegal conduct. The Report of the Special Study has recommended that the responsibilities of self-regulatory agencies be substantially expanded and that their self-regulation be made more vigorous and effective. These recommendations thus contemplate an even greater degree of reliance upon self-regulation, although under somewhat more intensive Commission supervision. In the light of these considerations and the desirability of uniform application of standards, it would be anomalous to allow any broker or dealer, at his option, to exempt himself from the structure of self-regulation simply by choosing not to join a self-regulatory agency. Such membership would accordingly be required, subject to a power in the Commission to grant such exemptions as it deems necessary and appropriate.

Registered securities associations are not private organizations. They are organized under statutory authority to perform, under Commission oversight, regulatory functions in the over-the-counter securities markets. The Commission has direct control over the membership policies of such associations. The Commission's approval is a prerequisite for adoption of any rule. The Commission can abrogate any existing rule of an association, and in many areas can affirmatively alter or supplement the rules of an association. An association's disciplinary actions and denials of membership are subject to review, as a matter of right, by the Commission and to further review by the appropriate U.S. court of appeals. In view of this oversight, the Commission believes that the proposed requirement of membership in a registered securities association poses no problems of lack of due process or objectionable delegation of powers.

Section 15A clearly provides that there can be more than one registered securities association. Therefore the requirement would not necessarily be one of membership in the NASD, at present the only registered securities association.

Some retailers of mutual fund shares which are presently not members of the NASD have indicated that they may want to form a new national securities association whose membership would be limited to dealers in mutual fund shares. Section 15A(b)(3) provides that an association may restrict membership therein on, among other bases, such specified basis relating to the type of business done as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purposes of section 15A. This is subject to the overriding explicit congressional declaration that registration as a national securities association is to be limited to associations which are a proper subject of national concern. (See H. Rept. 2307, 75th Cong., 3d sess. (1938), p. 6.) Thus, an applicant association whose membership is limited to dealers primarily engaged in the distribution of mutual fund shares could meet section 15A(b)(3), if the business of its members is sufficiently substantial to be a proper object of national concern. Such an association would of course have to meet the other requirements of section 15A in order to become registered. These other requirements relate primarily to the content of the rules of the association and are designed to insure that the association will operate fairly and in the public interest. A new association would have little trouble in conforming its rules to these requirements, especially with the benefit of the precedent of the NASD rules.

At the present time, the great bulk of active over-the-counter brokers and dealers find it economically necessary to be members of the National Association of Securities Dealers, Inc., because the bylaws of the association provide, as authorized by section 15A(i) of the act, that no member shall deal with a nonmember broker or dealer except at the same prices and upon the same terms as such member deals with the public. This means, for example, that nonmember brokers and dealers cannot, as a practical matter, obtain underwriting discounts or commissions as participants in distributions by members. A limited number of brokers and dealers, however, do not do interdealer business or participate in underwritings but retail securities directly to the public; and it is primarily this group, which would include a number of retailers of mutual fund shares and real estate securities, which would be brought under the self-regulatory scheme by this requirement.

As of February 28, 1962, when the Special Study surveyed the matter, there were 5,785 registered broker-dealers, of whom 4,750 were members of the NASD. This left 1,035 nonmember broker-dealers. Of these, approximately 40 percent were either new firms who had not yet commenced business or existing firms which had gone out of business but had not withdrawn their registrations. About 9 percent were exchange members who presumably do a very limited over-the-counter business; and approximately 20 percent were not engaged in what is generally regarded as the securities business but dealt primarily in real estate, oil royalties, savings and loan shares, insurance, etc. Many firms in the above two categories would probably qualify for exemption under the Commission's rule-making power. This leaves approximately 300 firms who would be the principal subjects of this amendment. Certain of these, however, including certain foreign dealers and investment advisers, might also qualify for exemption.

Standards of competency, experience, character, and capital

At the present time, anyone who has not been guilty of a specified act of misconduct set forth in section 15(b) of the Securities Exchange Act may enter the securities business either as a principal or as an employee. The findings of the Special Study confirm the view of the Commission that, because of the complex nature of the securities markets, the reliance which the investing public necessarily places upon the competence and character of professionals in those markets, and the responsibilities which are assumed, the existing ease of entry for inexperienced or unqualified persons subjects the investing public to undue hazards and unnecessarily complicates the task of regulation.

These hazards are illustrated in an analysis by the Special Study of violations committed by broker-dealer firms. Almost 28 percent of the new firms registering with the Commission during the first 3 months of 1961 had no experienced persons among their principals (proprietors, partners, officers, and large stockholders), and over 50 percent of the firms were in the hands of persons with under 2 years of experience. Examination disclosed that the newest member firms of the NASD, which are generally controlled by persons having less

experience than principals of older firms, were responsible for a much higher percentage of the offenses drawing the most severe penalties in disciplinary actions. During the period 1959–61, the NASD expelled 105 firms. Of these 105 firms, 47, or 44.8 percent, were firms admitted to membership in 1959–60; only 2, or 1.9 percent, were firms admitted before 1941. Yet, during the period 1959–61, firms admitted before 1941 and firms admitted during 1959–60 constituted about equal percentages of total NASD membership—22.8 percent and 24 percent, respectively. Also, in 1959–61, of the disciplinary cases that arose out of member examinations and that were decided by the NASD district committees, 48 percent arose out of first examinations of respondent members. These offenses by new firms often appear to be attributable to the principals' lack of familiarity with the technical and financial aspects of the business.

Certain of the securities exchanges, particularly the New York Stock Exchange, have endeavored to establish standards of competence, experience, character, and capital, but these standards apply only to personnel of member firms. The rules adopted by the NASD in this area, while good as far as they go, should be expanded. It is consequently proposed that registered securities associations be expressly authorized and required to establish suitable standards. Development and administration of such standards is a matter which is peculiarly appropriate for self-regulation under Commission supervision; and the establishment of such requirements in conjunction with the requirement of membership in a self-regulatory body, will significantly simplify regulation and improve investor protection.

Direct disciplinary power over individuals

At the present time, if an individual member or employee of a securities firm defrauds customers or otherwise violates the law without the approval of, or perhaps even without the knowledge of, his employer, the Commission can take disciplinary action only by a proceeding against the entire firm, which, particularly in the case of large firms, may involve many people wholly innocent of the violations in question. This approach is awkward and may be unfair, and for this reason, violations by individuals may sometimes go unpunished. The Special Study has demonstrated the correctness of the long-held Commission view that, for many purposes, the individual is an appropriate unit for regulation, in the interest of fairness as well as efficiency. Accordingly, the Commission would be authorized to proceed directly against offending individuals, in lieu of proceeding against the entire firm, where that course is appropriate. The stock exchanges already have and exercise this power and the NASD proceeds against individuals, but it may do so only as part of a proceeding against a firm. Under the proposed amendments, a registered securities association would be authorized to proceed against an individual without proceeding against the firm. This proposed change would not reduce the responsibility of a firm to supervise its employees.

Imposition of lesser sanctions in disciplinary proceedings

If, in a proceeding against a broker or dealer, the Commission finds violations of law, it is often confronted with the choice of revoking the registration of a firm altogether (thus putting it out of business), imposing no sanction at all, or else suspending the firm's membership in the NASD or an exchange if the firm happens to be a member. The impact of such a suspension upon a firm varies greatly depending upon the nature of that firm's business. In order to avoid the all-or-none choice between revocation or no sanction, it is proposed to permit the Commission to suspend registration for an appropriate period not to exceed 12 months or to issue a formal censure.

Broadening of grounds for denial or revocation of registration

The category of offenses and injunctions which form the basis for disciplinary proceedings under section 15(b) would be enlarged to conform to the latest category specified by Congress: that found in the Investment Advisers Act of 1940 as amended in 1960. It would include not only offenses and injunctions involving securities transactions or the securities business but would also include other types of financial offenses which equally reflect upon a person's suitability to handle other people's funds and investments. In addition, this change will conform the Securities Exchange Act to the pattern of the Investment Advisers Act. Many firms are registered under both acts, and the change would avoid the anomaly which could happen under existing law of a firm continuing to be registered under the Securities Exchange Act, although its registration under the Investment Advisers Act has been revoked.

A new paragraph (E) is added, making aiding and abetting in a violation by another person an additional basis for disciplinary proceedings. This likewise conforms to the 1960 amendments to the Investment Advisers Act, with the addition that failure reasonably to supervise persons who engage in violations is also made a ground for disciplinary action. The Commission has long held that brokers and dealers have a duty to supervise their employees; and under existing law, violations committed by employees and others connected with the firm are a basis for disciplinary proceedings. This change will, however, expressly state, on the face of the statute, the law on this matter, which becomes more important in view of the proposed authority for the Commission to proceed directly against individuals. The Special Study has demonstrated that proper supervision is of cardinal importance in maintaining proper standards in the operations of a securities business. Failure reasonably to supervise is a ground for disciplinary action under the Uniform Securities Act, which is in force in many States.

Removal of requirement of showing of use of mails or a facility of interstate commerce in case of violations by a registered broker-dealer

The provision dispensing with proof of the use of the mails or jurisdictional facilities in the case of proscribed acts by brokers or dealers registered with the Commission will avoid situations where fraud or other offenses by such federally registered firms go unpunished simply because no use of these facilities in the particular transaction can be shown.

Moreover, under present law, a substantial amount of time and effort has to be spent in the essentially useless effort of collecting envelopes, or other evidence that the mails or facilities of interstate commerce were utilized in the particular transactions under investigation, in order to prove a case against an offending broker or dealer. This is an unnecessary waste of the taxpayers' money and diverts the Commission's enforcement resources from more productive tasks in protecting the investing public. A broker or dealer voluntarily subjects himself to Federal jurisdiction when he registers with the Commission, and there is no constitutional or other necessity that, or any good reason why, the Commission's power to discipline him for violations of law should depend upon the happenstance that Federal instrumentalities were utilized in the particular unlawful transactions. There is precedent for this in existing law. Sections 7 and 8 of the Securities Exchange Act (which sections deal with margin transactions, borrowings, and hypothecation or lending of customers' securities) prohibit certain acts by members of a national securities exchange and brokers or dealers transacting business through the medium of such members, whether or not the mails or any facility of interstate commerce are used. Also, section 16 of the Securities Exchange Act imposes certain liabilities and responsibilities upon insiders of an issuer with an equity security listed on a national securities exchange regardless of the use or nonuse of the mails or a means of interstate commerce in specific transactions. The constitutionality of subsection (b) of section 16 (the profit-recovery portion of that section) has been litigated and has consistently been upheld by the courts as a valid exercise by Congress of the commerce power. See, e.g., *Gratz* v. *Claughton*, 187 F. 2d 46 (2d Cir. 1951), cert. denied, 341 U.S. 920, and *Smolowe* v. *Delendo*, 136 F. 2d 231 (2d cir. 1943), cert. denied, 329 U.S. 751.

In addition, the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940 require, respectively, holding companies and investment companies that utilize the mails or instrumentalities of interstate and foreign commerce to register with the Commission, and thereafter many of the detailed requirements and prohibitions applicable to such companies and their affiliated persons are applicable whether or not the mails or interstate facilities are used in the transactions referred to. The Supreme Court has held that the statutory pattern of the Public Utility Holding Company Act of 1935 is a valid exercise of the commerce power by Congress. See *American Power & Light Co.* v. *SEC*, 329 U.S. 90 (1946); *North American Co.* v. *SEC*, 327 U.S. 686 (1946); and *Electric Bond & Share Co.* v. *SEC*, 303 U.S. 419 (1938).

The application of the Securities Exchange Act to these transactions would, of course, continue to depend ultimately on the interstate commerce clause and the use of the mails, for a broker-dealer would be required to register with the Commission only if he makes use of the mails or a means or instrumentality of interstate commerce.

Requiring all broker-dealers using the mails or any facility of interstate commerce to effect over-the-counter transactions to register with the Commission: Elimination of "exclusively intrastate" exemption

At present, a broker or dealer whose business is "exclusively intrastate" is exempt from registration under the Securities Exchange Act. The preservation of this exemption under present conditions creates a gap in the regulatory pattern for investor protection, which will become more striking if all other brokers and dealers are required to become members of self-regulatory bodies. The scope of this exemption is very narrow and only a small number of brokers and dealers can avail themselves of it. Such brokers and dealers are already subject to the antifraud rules of sections 10(b), 15(c)(1), and 15(c)(2) and the financial responsibility requirements of section 15(c)(3).

The Commission thus has a statutory responsibility for the conduct of these broker-dealers that is almost identical with its responsibility for the conduct of other broker-dealers. But in two important respects, it does not have equivalent means of enforcement. Since such intrastate broker-dealers are not required to register, the Commission does not learn of their existence except as a result of a complaint. Also, section 17, which gives the Commission power to prescribe books and records to be made and maintained by registered broker-dealers and broker-dealers who are members of a national securities exchange, and which gives the Commission the right to inspect such books and records, is not applicable to such "intrastate" broker-dealers. It is indeed anomalous that these broker-dealers are subject to the capital requirements prescribed under the statute, but are not required under section 17 to keep any records to show how much capital they have. As a result of these handicaps, the Commission is compelled to devote an amount of time and effort to fraud investigations involving intrastate brokers and dealers that is out of proportion to their numbers or their importance; and, as a practical matter, it cannot effectively enforce the capital requirements as to such brokers and dealers. Furthermore, such brokers and dealers are wholly outside the scope of the pattern of self-regulation, which is otherwise such a significant part of the statutory scheme.

In order to qualify for the exclusively intrastate exemption, a broker-dealer must not only deal with customers who are exclusively within the State, but he must deal exclusively in securities originating in the State. Information obtained in the course of investigations indicates that intrastate broker-dealers quite frequently overstep these restrictions and thus involve themselves in inadvertent violations of Federal law. Where these restrictions are in fact observed, the broker-dealer is strictly limited in the securities which he may recommend and sell to his customers and, for example, cannot deal in any securities listed on the New York Stock Exchange or in mutual fund shares. It is unfortunate that any broker-dealer is given an incentive thus to limit the selection of securities that he recommends to his customers, since the very securities that he cannot recommend might well be the ones which the customer should have. In addition, if the Commission is to have power to suspend the registration of a broker or dealer for a limited period, the broker or dealer should not be able to ameliorate the impact of that suspension by conducting an exclusively "intrastate" business during the period specified.

"Intrastate" broker-dealers of course have an effect on interstate securities markets. Few securities have a market limited to one State, and transactions in a security in one State affect the market for the security in other States. Also, few issuers of securities engage in a business that is not interstate or which does not affect interstate commerce.

In summary, "intrastate" broker-dealers using the mails or means of interstate commerce are already subject to substantially the same body of Federal rules as are registered interstate broker-dealers. The primary effect of this change would be to provide the Commission with the enforcement powers with respect to such broker-dealers that it now has with respect to registered interstae broker-dealers; by doing so, the Commission's enforcement responsibilities could be more easily discharged, resulting in savings for the taxpayers. The application of the Securities Exchange Act to these broker-dealers would, of course, continue to depend upon the interstate commerce clause and the use of the mails, for they would be required to register with the Commission only if they make use of the mails or means or instrumentalities of interstate commerce.

Amendments with respect to registered securities associations

In addition to those fundamental amendments already discussed which concern registered securities associations—required membership in such an agency and the establishment of qualification standards—there are also a series of proposals designed in a few respects to clarify or strengthen present law with respect to registered securities associations.

First, an increasing scope for responsibility by registered securities associations is reflected by requiring their adoption of rules designed to produce fair and informative quotations of over-the-counter securities. This will clarify the authority of associations in this area and further impose upon them a responsibility to act. It is not a resolution of the problems affecting over-the-counter quotations, but a means for dealing with some of them.

Second, the bill would shorten from 60 to 30 days the time for appealing to the Commission from disciplinary action or denial of membership by a registered securities association. This reduction will expedite Commission review proceedings and still allow ample time for appeals. This section also provides that the Commission may order, after a hearing, that an appeal from disciplinary action by an association will not stay the judgment of the association pending final decision on review by the Commission. At present, an appeal automatically operates as a stay. It is contemplated that this new power to lift the stay would be sparingly employed; however, its use would be proper where an appeal is clearly taken for delay and injury to the public should be prevented pending Commission action.

Finally, a registered securities association would be authorized to adopt rules, subject to Commission approval, which would permit exclusion from its membership of persons who have been suspended or expelled from an exchange for violation of any of the exchange's rules. It is anticipated that only serious misconduct of a nature affecting the protection of investors would be grounds for exclusion, and any such action would be subject to Commission review. This section would resolve a problem existing primarily between the NASD and the New York Stock Exchange with regard to the collateral effects of the latter's disciplinary proceedings.

Mr. HARRIS. The chairman has just called to my attention another statement, a technical statement of the Securities and Exchange Commission.

Mr. CARY. This, Mr. Chairman, is a detailed, paragraph-by-paragraph analysis of the bill. It is a somewhat different approach than that taken in either the justification or in my statement this morning. I thought perhaps you might like to have it. It would also indicate, for instance, there were some technical changes made by the Senate when it passed the bill to which we advert.

Mr. HARRIS. I would suggest that this be included in the record, Mr. Chairman.

Mr. STAGGERS. It shall be done.

(The material to be furnished follows:)

TECHNICAL STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 6789, H.R. 6793, AND S. 1642

This detailed, technical section-by-section analysis is divided into parts A, B, and C. Part A discusses sections 3, 4, 5, 6(c), 6(d), 8, 9, 10, and 11 of the bills, which would amend sections 12, 13(a), 14, 15(c), 15(d), 16, 20(c), and 32(b) of the Securities Exchange Act of 1934 and section 4 of the Securities Act of 1933, respectively. These sections of the bills relate primarily to the extension of the disclosure and other shareholder protections of the Securities Exchange Act of 1934 to widely held over-the-counter companies.

Part B deals with sections 2, 6(a), 6(b), and 7 of the bills, which would amend sections 3(a), 15(a), 15(b), and 15A, respectively, of the Securities Exchange Act of 1934. These sections of the bills relate primarily to improved qualifications and self-regulation for those engaged in the securities business.

Effective date provisions are contained in section 12 of the bills, discussed in part C of this analysis. Most of the provisions of the bills would be effective upon enactment, but several become effective on July 1, 1964.

As introduced, S. 1642 was identical to H.R. 6789 and H.R. 6793. The Committee on Banking and Currency of the U.S. Senate, however made editorial, clarifying, technical, and a few substantive changes in S. 1642 as reported by that committee. The U.S. Senate passed S. 1642 as reported by that committee. This statement discusses S. 1642, as passed by the U.S. Senate, except where otherwise specifically noted, and references to "the bill" refer to S. 1642. However, in almost all cases, the discussion is equally applicable to the other two bills, and substantive differences in the three bills are noted.

PART A: EXTENSION OF DISCLOSURE AND OTHER SHAREHOLDER PROTECTIONS OF THE SECURITIES EXCHANGE ACT TO WIDELY HELD OVER-THE-COUNTER COMPANIES

Section 3(a), amending section 12(b)(1)(I)—Material contracts in applications for registration

Section 3(a) of the bill would amend subparagraph (I) of section 12(b)(1) expressly to empower the Commission to require that applications for registration of securities on a national securities exchange contain information with respect to material contracts (including material patents and contracts for material patent rights) not made in the ordinary course of business. A paragraph (3) would be added to section 12(b) to authorize the Commission to require copies of such contracts to be filed as a part of the application. Subparagraphs (I), (J), and (K) of existing section 12(b)(1) would be relettered subparagraphs (J), (K), and (L), respectively.

Section 12(a) of the act now requires that the issuer of a security file an application for registration with both the appropriate exchange and the Commission, as a prerequisite to the listing and registration of a security on a national securities exchange. Subsection (b) of section 12 specifies the information and documents that the Commission may require to be contained in an application for registration. These include such relevant information and documents in such detail as the Commission may require as to the issuer's business; its outstanding securities; the identity and the remuneration of officers, directors, and principal shareholders; their interests in the securities of, and their material contracts and interests in transactions with, the issuer; bonus and profit-sharing arrangements; management and service contracts and options which are existing or are to be created in respect of the issuer's securities. An application must also contain balance sheets and profit-and-loss statements, certified by independent public accountants if so required by the Commission's rules or regulations, and such further financial statements as the Commission may deem necessary or appropriate for the protection of investors.

This amendment would close a significant gap in the information requirements of section 12(b). The disclosures to be required would be limited to material contracts, not made in the ordinary course of business, which are to be performed in whole or in part at or after the filing of the application or which were made not more than 2 years before such filing. Under new section 12(g)(1) the Commission could require comparable information and documents to be included in a registration statement with respect to over-the-counter securities registered pursuant to that section. The Commission has adequate authority to adopt appropriate rules to insure that these disclosure requirements will not be unduly burdensome to business. Similar disclosures are now required in a registration statement under the Securities Act. Registration forms adopted under that act specify the various types of contracts which are deemed to be material, and the Commission will develop similar criteria for applications for registration and registration statements filed under subsection (b) and new subsection (g) of this section. Under section 24 of the act the Commission has authority to grant confidential treatment when necessary for the protection of trade secrets and other information.

This amendment would not take effect until July 1, 1964, the effective date of section 12(g)(1).[1]

Section 3(b), Amending section 12(f)—Unlisted trading privileges

Section 3(b) of the bill would amend, in several respects, section 12(f) of the Exchange Act, which specifies the conditions and procedures for the continuation, extension, suspension, and termination of trading privileges on national securities exchanges for unlisted securities. Many of the changes are only technical and necessitated by other substantive amendments. The principal

[1] In H.R. 6789 and H.R. 6793, this amendment would become effective upon enactment.

amendments relate to the preservation of existing trading markets for securities now admitted to unlisted trading on exchanges; the repeal of existing provisions for extension of unlisted trading privileges to securities of issuers subject to disclosure requirements equivalent to those applicable to issuers of listed securities; the clarification of the Commission's authority to extend, suspend, and terminate unlisted trading privileges; and the deletion of unnecessary provisions with respect to quotations of unlisted security transactions by exchanges.

Clause (1) of section 12(f) now provides that any national securities exchange may continue unlisted trading privileges for securities which were admitted to trading on such exchange before March 1, 1934. Clause (2) permits the extension by an exchange of unlisted trading privileges to securities which are listed and registered for trading on another national securities exchange. Clause (3) permits exchanges to extend unlisted trading privileges to any security as to which the disclosure requirements and other duties and obligations of the issuer and its management are substantially equivalent to those applicable to listed securities. Application to, and approval by, the Commission are prerequisites to action by an exchange under these clauses. Other provisions of section 12(f) specify the conditions and procedures for the continuation, extention, suspension, and termination of unlisted trading privileges under these clauses.

1. *Changes in clause (1).*—Section 3(b) of the bill would amend clause (1) to provide for continuation, without further application to, and approval by, the Commission of unlisted trading privileges for securities admitted on an exchange prior to July 1, 1964, the effective date of the new section 12(g)(1) of the act. This would preserve existing trading markets for many securities to which the Commission, since March 1, 1934, has extended unlisted trading privileges under clause (2), and for a few other securities admitted to unlisted trading under clause (3). Unlisted trading privileges for securities originally admitted under clause (2) would continue only so long as such securities are listed and registered for trading on another securities exchange. Since applications to continue unlisted trading privileges would not be filed, the first sentence of the second paragraph of section 12(f) (relating to Commission action on applications under this section) would be amended by deleting the reference to such applications for continuation.

2. *Repeal of clause (3).*—Existing clause (3) has had very limited application, particularly since 1945 when the Commission held that it could make the required finding of equivalency in the duties and obligations of unlisted securities of an issuer and its management with those applicable to issuers of listed securities only for a corporation subject to such obligations under special statutes. In practice, such statutes have been limited to the Public Utility Holding Company Act of 1935. There have been no applications under this clause since 1949. The extension of such duties and obligations to a substantial segment of over-the-counter securities, as proposed in this bill, would give clause (3) a large and unintended scope. To assure that companies with over-the-counter securities registered pursuant to new section 12(g)(1) of the act would be required to comply with the listing requirements of the various exchanges as a prerequisite to trading on such exchanges, clause (3) of section 12(f) would be repealed. The provisions in the second paragraph of 12(f) relating to the procedures and conditions for approval of applications under clause (3) would also be deleted.

3. *Changes in clause (2) and clarification of the Commission's authority.*—The bill would amend section 12(f) to reflect the fact that since no further applications would be filed under clause (1) and since clause (3) would be deleted, the provisions for application to, and approval by, the Commission of extensions of unlisted trading privileges would apply only to applications under present clause (2). The bill would also delete the various specific criteria for the granting of applications and for the termination of unlisted trading privileges previously granted under these clauses. These criteria would be replaced by paragraphs authorizing the Commission to extend unlisted trading privileges or to suspend or terminate such privileges if it finds, after notice and opportunity for hearing, that such action is necessary or appropriate in the public interest or for the protection of investors. This amendment would clarify the Commission's authority to consider all factors relevant to the public interest or the protection of investors in connection with the extension, termination, or suspension of unlisted trading. The Commission would continue to consider the criteria now specified in the act insofar as they are relevant to a determination of the public interest in the particular case.

4. *Quotations of unlisted securities by exchanges.*—The bill would delete the last sentence of the second paragraph of section 12(f), which now provides that a national securities exchange must clearly differentiate in the publication of quotations between transactions in listed securities and transactions in securities with unlisted trading privileges. Under section 19(b) the Commission has authority to alter or supplement the rules of national securities exchanges so that they require such differentiation. Since the Exchange Act does not compel newspapers and other communications media to differentiate between quotations and transactions in listed and unlisted securities traded on a national securities exchange, these provisions of section 12(f) serve no useful purpose.

Section 3(c), proposed section 12(g)—Registration of over-the-counter securities

Section 3(c) of the bill would add a new subsection (g) to section 12 of the Exchange Act to provide for disclosures by certain issuers of securities traded in the over-the-counter market comparable to those required of issuers of listed securities by section 12(b) of the Exchange Act. Paragraphs (1) through (4) relate to the requirements of registration, exemptions from registration, termination of registration, and definitions of certain terms.

1. *The requirement of registration.*—Paragraph (1) of this subsection would require any issuer which has total gross assets in excess of $1 million to file a registration statement with the Commission for any class of its equity securities (other than an exempted security) held of record by 500 or more persons, if the issuer is engaged in interstate commerce, or a business affecting interstate commerce, or its securities are traded by use of the mails or any means or instrumentality of interstate commerce. However, registration would not be required for any class of equity security held of record by less than 750 persons until after July 1, 1966, or for such longer time as the Commission may prescribe. Provision is also made for voluntary registration of any class of equity security not required to be registered.

To provide a reasonable opportunity for preparation of the information and documents to be included in a registration statement, it need not be filed until 120 days after the end of a company's first fiscal year in which the statutory tests are first met. These statutory tests would be applied as of the last day of a company's fiscal year. In addition, the registration statement would not become effective until 60 days after it is filed, unless accelerated by the Commission upon request. Until the effective date of the registration statement, it would not be deemed filed for the purposes of the civil liability sanctions of section 18 of the Exchange Act.

The effective date of the new subsection 12(g)(1) would be July 1, 1964. Thus, except for issuers with fiscal years ending between July 1 and September 1, 1964, issuers generally would first be subject to the registration requirement in 1965. The Commission would be authorized to extend the registration date for any issuer or class of issuers.

Although paragraph (1) would require only one filing of a registration statement in respect of each class of an issuer's equity securities held of record by the specified number of persons, a separate registration statement would have to be filed for each such class of securities. However, under section 12(b) of the Exchange Act the Commission has adopted rules, regulations, and forms which permit summary registration of securities and incorporation by reference for companies which already have another class of securities registered for trading on a national securities exchange. The Commission would adopt similar procedures to eliminate duplication of filings by companies which have another class of securities registered pursuant to the provisions of section 12(b) or of new section 12(g)(1).

The registration statement would include such information and documents as the Commission may require comparable to that now required in an application to register a security for trading on a national securities exchange. In addition to the power to exempt and classify contained in new section 12(h), the Commission would have authority under the provisions of this paragraph to permit certain categories of issuers to file information in summary or abbreviated form.

Issuers subject to the provisions of this paragraph would be required to file such copies of the registration statement as the Commission may require. Thus, the Commission could require that copies be filed in one or more of its regional offices for more convenient inspection by members of the financial community and the investing public. In addition, through the use of modern

reproduction processes, copies could be made available at moderate cost upon request of interested persons. Section 24 of the Exchange Act empowers the Commission to extend confidential treatment to trade secrets and other information required to be filed.

2. *Exemptions from registration.*—New section 12(g)(1) provides that registration would not be required if the class of equity securities held of record by more than 500 persons is an "exempted security" as defined in section 3(a)(12) of the Exchange Act. The term "exempted security" includes direct obligations of, and obligations guaranteed by, the United States, or a State or political subdivision thereof, and such other securities as the Commission may by rules and regulations define as exempted securities.

In addition, subparagraphs (A) through (D) of paragraph (2) of new section 12(g) would provide exemptions for securities listed and registered on a national securities exchange; securities issued by registered investment companies; share accounts in savings and loan associations, building and loan associations, cooperative banks, homestead associations, and similar institutions; and securities issued by charitable organizations. Disclosure requirements equivalent to those proposed by the bill already apply with respect to securities registered and listed on a national securities exchange and securities issued by registered investment companies. There is normally no trading interest in the remaining categories of securities exempted from the registration provisions.

Equity securities issued by banks and stock insurance companies and permanent stock, guaranty stock, permanent reserve stock, or the like, issued by a savings and loan association would not be exempt from the requirement of registration. Mutual insurance companies would not be subject to section 12(g).

Subparagraph (E) would also exempt from registration securities issued by foreign issuers and certificates of deposit issued against such securities. The Commission could terminate the exemption for any such security or class or classes of securities by rule and regulation, or by order, only if it finds that a substantial public market exists in the United States and that continued exemption is not in the public interest or is not consistent with the protection of investors. The Commission could act by order only after notice and opportunity for hearing. Initiation of hearings to terminate the exemption would rest in the sole discretion of the Commission,[2] since, in some cases, such action could have an adverse effect on trading in the security. Any person could, however, request the Commission to hold such hearings.

3. *Termination of registration.*—Paragraph (3) of subsection (g) would provide for the termination of registration of a class of securities when the record ownership of that class is reduced to less than 300 holders. Registration would be terminated 90 days, or such shorter period as the Commission may determine, after a certification to such effect is filed. The Commission would have authority, after notice and opportunity for hearing, to deny termination of registration if it finds that a certification is untrue.. Termination of registration would be deferred pending a final determination on the question of denial.

Notwithstanding termination of registration, information, documents, and reports in respect of periods while a security was registered would be required. For example, if a calendar year issuer first registering a security under section 12(g)(1) on March 1, 1966, validly terminates registration on March 1, 1968, information, documents, and reports in respect of events happening in 1968 before March 1 of that year and information, documents, and reports in respect of events happening in 1967 would nevertheless be required to be filed.

If registration is terminated, reregistration would be required if the statutory tests of section 12(g) were again met.

4. *Definition of terms.*—Paragraph (4) of subsection (g) would define the term "class" for the purposes of this subsection to include all securities of an issuer which are substantially similar in character and the holders of which enjoy substantially similar rights and privileges. Paragraph (4) would also grant the Commission specific rulemaking authority to define the terms "total assets" and "held of record" for the purposes of this subsection. This would

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[2] S. 1642 so provides. H.R. 6789 and H.R. 6793 would require the Commission to hold a hearing upon the application of any interested person. The Commission believes that S. 1642 is more desirable in this respect; the mere initiation of such a hearing could in some cases have an adverse effect upon the trading in the security without any corresponding benefit to the public.

not limit the Commission's existing authority under section 3(b) of the Exchange Act to define technical, trade, and accounting terms. Although the terms "total assets" and "held of record" probably would fall within the scope of section 3(b), this provision would clarify the Commission's authority as to these terms and insure adequate power to prevent circumvention of the statutory standards for registration. Under section 3(b) the Commission could define the term "class" for the purposes of this subsection in a manner not inconsistent with the definition contained in paragraph (4) of subsection (g).

Section 3(d), proposed section 12(h)—Power to exempt and classify issuers

Section 3(d) would amend section 12 of the Exchange Act by adding a new subsection (h), which provides flexibility in the administration of the provisions of the bill with respect to securities traded in the over-the-counter market. This subsection would empower the Commission to exempt in whole or in part any issuer or class of issuers from the registration, reporting, and proxy provisions of sections 12(g), 13, 14, and 15(d) and to exempt any person from the insider trading provisions of section 16. The Commission also would be specifically empowered to classify issuers and prescribe appropriate requirements for different issuers or classes of issuers. Thus, the Commission would have ample authority to modify, and provide exemptions from, the statutory requirements for different issuers on the basis of the number of shareholders, trading interest in their securities, nature and extent of their business activities, income, asset size, or other relevant considerations.

Section 3(e), proposed section 12(i)—Bank securities

Section 3(e) of the bill [a] would add a new subsection (i) to section 12 of the Exchange Act to vest in the various Federal banking regulatory agencies the powers, functions, and duties granted to the Commission to administer and enforce sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act with respect to securities issued by banks under their jurisdiction. The authority to administer and enforce these provisions would rest with the Comptroller of the Currency with respect to securities issued by national and District of Columbia banks, the Board of Governors of the Federal Reserve System with respect to State member banks except District of Columbia banks and the Federal Deposit Insurance Corporation with respect to insured banks which are not members of the Federal Reserve System, except District of Columbia banks. If a State bank that is not a member of the Federal Reserve System and not insured by the Federal Deposit Insurance Corporation becomes subject to sections 12, 13, 14(a), 14(c), and 16 of the act, the Commission would administer and enforce these sections with respect to such a bank.

For the purpose of exercising the functions vested in them by this section, these designated Federal banking agencies would have the authority vested in the Commission under any provision of the Exchange Act. This would include, but would not be confined to, the power to define technical, trade, and accounting terms under section 3(b) of the act; the power to adopt rules and regulations necessary for the execution of their functions under the act pursuant to section 23(a) of the act; and the power, under section 24 of the act, to extend confidential treatement to information filed with them pursuant to the provisions of the act. Pursuant to new section 15(c)(4) the appropriate banking agency would have the power to issue an order to compel compliance with sections 12 and 13 of the act. For violations of sections 12, 13, 14(a), 14(c), and 16 of the act, it would be able to delist a security from a national securities exchange under the authority of section 19(a)(2) of the act and summarily to suspend trading in a security pursuant to new section 15(c)(5) and section 19(a)(4) of the act.

The bank agency would also have the power conferred on the Commission under section 21 of the act to investigate, to apply to a court to enjoin, and to forward to the Attorney General for prosecution violations of sections 12, 13, 14(a), 14(c), and 16 of the act. The jurisdiction of the Federal banking regulatory agencies over any bank will be the same, therefore, whether the securities of that bank are listed on a national securities exchange or registered under the new

[a] The description in the body of the statement relates to S. 1642. H.R. 6789 and H.R. 6793 differ from S. 1642 in that they provide that each of the Federal banking regulatory bodies shall, upon request to the Commission, have such powers, functions, and duties in respect of securities issued by banks under their jurisdiction. If a Federal banking regulatory agency were not to make such a request, all powers, duties, and functions in respect of securities issued by banks under the jurisdiction of that agency would remain in the Commission. Thus, H.R. 6789 and H.R. 6793 would give each of the Federal banking regulatory agencies an option.

section 12(g)(1). The powers, functions, and duties of such agencies provided by the Exchange Act would be in addition to all powers, functions, and duties conferred on them under any other provision of law.

Section 4, amending section 13—Periodic reporting requirements

Section 4 of the bill would amend section 13 of the Exchange Act, which now applies only to issuers of securities registered on a national securities exchange, to require that companies with securities registered under section 12(g) keep reasonably current the information and documents contained in a registration statement and to file such annual and other periodic reports as the Commission may prescribe.

The Commission would have authority under new section 12(h) and the existing provisions of section 13 to make appropriate modifications of these requirements for various issuers or classes of issuers. Section 24 of the Exchange Act, relating to confidential treatment for trade secrets and other information filed with the Commission, would be available to all companies filing information, documents, and reports pursuant to this section. A new sentence added to the end of section 13(a) would require that issuers of listed securities file with the exchange a duplicate original of information, reports, and documents required under this section, instead of originals as now provided.

Paragraph (1) of section 13(a) would be amended to state specifically that the information and documents filed pursuant to section 12 of the act, as to which current reports may be required, relate to those required to be included or filed with an application for registration under section 12(b) or a registration statement under new section 12(g). This would clarify the Commission's authority to require that applications for registration already filed, as well as applications and registration statements filed in the future, disclose the terms, and contain copies, of material contracts not made in the ordinary course of business, as provided by the amendment to section 12(b), contained in section 3(a) of the bill.

Sections 5(a) and 5(b), amending sections 14(a) and 14(b)—Proxy controls

1. *Amendment to section 14(a).*—Section 5(a) of the bill would amend section 14(a) of the Exchange Act to make it unlawful for any person, in contravention of the Commission's rules and regulations, to solicit, or to permit the use of his name to solicit, proxies in respect of any security registered pursuant to section 12 of the act. The Commission's rulemaking authority under this section is now limited to proxies relating to securities listed and registered on a national securities exchange. The effect of this amendment would be to permit the Commission to adopt rules governing the solicitation of proxies in respect to over-the-counter securities registered under new section 12(g).

2. *Amendments to section 14(b).*—Section 5(b) of the bill would amend section 14(b) of the Exchange Act to make it unlawful for members of a national securities exchange and brokers and dealers registered with the Commission pursuant to section 15 of the act to give, in contravention of such rules as may be prescribed by the Commission, proxies, consents and other authorizations in respect of any security which is registered under section 12 of the act and carried for the account of customers. The Commission's rulemaking authority under section 14(b) is now limited to the giving of proxies in respect to listed securities carried for the account of customers by members of the national securities exchanges and by broker-dealers who conduct business through the medium of an exchange member. The amendment would extend such authority to over-the-counter securities registered under new section 12(g) of the act and carried for the account of customers by any registered broker or dealer. Since registered broker-dealers include those who transact business through the medium of an exchange member, the present provision of section 14(b) referring to these brokers and dealers would be deleted.

Section 14(b) would be amended further to authorize the Commission to prescribe rules and regulations under which exchange members and registered broker-dealers could not refrain from giving a proxy with respect to securities held in street name for the account of customers. Section 14(b) now provides rulemaking authority only for the giving of proxies. A broker or dealer could avoid complying with such rules simply by not giving a proxy. In the absence of authority to require broker-dealers to give proxies, the Commission has considered it impractical to adopt rules under the existing provisions of section 14(b).

At the present time the New York Stock Exchange and certain other national securities exchanges have adopted rules which specify the conditions under which broker-dealers may vote proxies with respect to securities held for their customers and require, upon payment of expenses by the solicitor, the transmission of proxy material to the beneficial owners and the giving of proxies in accordance with their directions. There are no comparable requirements for broker-dealers who are not members of these securities exchanges.

The amendment would enable the Commission to adopt uniform rules applying to all broker-dealers with respect to the transmittal of proxy solicitation materials and the giving of proxies with respect to both listed and unlisted securities. Any requirements adopted by the Commission with respect to the transmittal by a broker-dealer of proxy solicitation materials would be conditioned upon the payment of necessary expenses by the issuer or other persons soliciting proxies.

Section 5(c), proposed new section 14(c)—Disclosure of equivalent information when proxies are not solicited

Section 5(c) would amend section 14 of the Exchange Act by adding a new subsection (c). This would empower the Commission to adopt rules and regulations to require issuers that do not solicit proxies in connection with an annual or other meeting of shareholders to file with the Commission and to transmit to record holders of its registered securities information substantially equivalent to that which would be required to be transmitted if a solicitation were made. The information would be distributed to shareholders prior to the annual or other meeting of shareholders and would pertain to all matters to be voted upon at such meeting as to which disclosure would be required in solicitation materials under the proxy rules. No such information would be required to be transmitted pursuant to the new section 14(c) before July 1, 1964.[4]

Section 6(c), amending section 15(c)—Enforcement power with respect to over-the-counter securities

1. *Power to compel compliance with provisions of sections 12, 13, and 15(d).*—Section 6(c) of the bill would amend section 15(c) of the Exchange Act by adding a new paragraph (4) to empower the Commission to determine, after notice and opportunity for hearing, whether any person subject to the requirements of sections 12, 13, or 15(d) has failed in any material respect to comply with any of those requirements. This would establish an administrative procedure, similar to that provided in proceedings to delist securities under section 19(a)(2) of the Exchange Act, for apprising investors of materially misleading filings and for the resolution of accounting and other complex and technical questions involving the disclosure provisions of the act. Under this paragraph the Commission could issue an order requiring compliance and, when the circumstances of a particular case so warrant, apply to a U.S. district court for enforcement of its order pursuant to the provisions of section 21(f) of the act. The express provision for publication of findings would in no way limit the Commission's existing powers under the Exchange Act or any other act to publish its findings in any other proceedings.

2. *Summary suspension of trading in over-the-counter securities.*—The bill would amend further section 15(c) of the act by adding a new paragraph (5), which would provide the Commission with authority summarily to suspend over-the-counter trading in any security (except an exempted security) for periods of 10 days. Broker-dealers would be prohibited from trading in any such security during the period or periods of suspension. This provision would be a counterpart to section 19(a)(4) of the Exchange Act, which provides for the summary suspension of trading in securities listed on a national securities exchange. As under section 19(a)(4), the Commission could invoke this suspension power in those cases in which fraudulent or manipulative practices of the issuer or other persons have deprived the security of a fair and orderly market, or where some corporate event makes informed trading impossible and provides opportunities for the deception of investors. Trading would be resumed as soon

[4] The July 1, 1964, effective date is provided in S. 1642. In the other two bills, the requirements of the new sec. 14(c) would become applicable upon enactment. The Commission believes the July 1, 1964, effective date preferable. July 1, 1964, is the effective date of the new sec. 12(g)(1), which would require certain over-the-counter issuers to register; and therefore, over-the-counter companies would in no event be required to comply with the new sec. 14(c) before July 1, 1964. Issuers with a security listed on an exchange should not be required to comply with the new sec. 14(c) any sooner than over-the-counter issuers that will be subject to the new sec. 12(g).

as adequate disclosure and dissemination of the facts material to informed investment decision were achieved.

Under section 19(a)(4), the Commission has issued more than one suspension when, upon reexamination at the end of the 10-day period, it has determined that another suspension is necessary. At the same time the Commission has recognized that suspension of trading in a security is a serious step, and therefore has exercised the power with restraint and has proceeded with diligence to develop the necessary facts in order that any suspension can be terminated as soon as possible. The Commission would follow that policy in administering the proposed new section 15(c)(5).

Section 6(d),[5] amending section 15(d)—Reporting requirements for companies filing a registration statement under the Securities Act of 1933

Section 6(d) of the bill would amend the provisions of section 15(d) of the Exchange Act, under which certain over-the-counter companies are subject to the reporting requirements of section 13 of the act. Section 15(d) now requires that a registration statement filed under the Securities Act must contain an undertaking to comply with the reporting requirements of section 13 if the value of the securities offered plus the value of all other outstanding securities of the same class amounts to $2 million or more. The duty to file is suspended if, and so long as, the value of securities outstanding is reduced to less than $1 million or the issuer has become subject to an equivalent reporting requirement.

Under the bill, section 15(d) would be amended to require every company filing, after the date of enactment of the bill, a registration statement under the Securities Act to file for the fiscal year in which the registration statement becomes effective such reports as may be required by the Commission under section 13. The duty to file reports for any later fiscal year would be suspended if, at the beginning of such fiscal year, the securities to which the registration statement relates are held of record by less than 300 persons; but if any Securities Act registration statement filed by the issuer at any time after the date of the enactment of the bill (regardless of the security to which the registration statement relates) becomes effective in such a year, then, as of the date of such effectiveness, such suspension would be lifted in respect of all of such year, and filings could be required in respect of any part or all of such year.

A company that files or has filed, on or before the date of enactment of the bill, a Securities Act registration statement that has become or becomes effective (whether on, before, or after the date of the enactment of the bill) generally would be obligated to file reports pursuant to the terms of the undertaking executed in accordance with the present provisions of section 15(d). However, in addition to the provisions for suspension of the duty to file specified in the undertaking, a company also would be relieved of reporting obligations for any period for which the obligation to file under section 15(d) is suspended under that section as amended by the bill. A company filing, on or before the date of enactment of the bill, one or more Securities Act registration statements that later become effective and filing, after the date of the enactment of the bill, one or more such registration statements that also become effective, would be obligated to file under section 15(d) if it is required to do so under either (1) any of the undertakings executed in accordance with the present provisions of section 15(d) with respect to the registration statements, filed on or before the date of the enactment of the bill or, (2) under the provisions of section 15(d), as amended by the bill; but the duty to file would be suspended in respect of any period provided in either of the suspension provisions of section 15(d), as amended by the bill.

The following example (dealing with B corporation, a hypothetical domestic industrial company whose only outstanding security from January 1, 1963, to July 1, 1966, is its common stock, whose fiscal year is the calendar year, and which at no time has any security registered under section 12 of the Securities Exchange Act), will illustrate the workings of section 15(d), as amended by the bill, in certain situations:

[5] The substance of sec. 6(d) of each of the three bills is the same, although the Committee on Banking and Currency of the United States Senate made several clarifying changes in this section of S. 1642. That Committee also deleted the original par. (3) of sec. 12 of the bill, which related to the effective date of the amendment to sec. 15(d) of the Exchange Act, because the original par. (3) could have been construed as being inconsistent with the amendments to sec. 15(d).

(a) B corporation files, in 1963 before the date of enactment of the bill, its first Securities Act registration statement, relating to its common stock. The registration statement becomes effective later in 1963. No further registration statements are filed or become effective in 1963 or in 1964; thus, B corporation's obligation to file under section 15(d) in respect of 1963 and 1964 will be determined solely by reference to the terms of its undertaking, which will be filed pursuant to the existing provisions of section 15(d). If on January 1, 1964, its common stock is held of record by less than 300 shareholders, it will be under no obligation to file in respect of the calendar year 1964, regardless of the number of shareholders of record at any later date in the year and regardless of whether filing would be required under the undertaking. There will be an obligation to file in respect of 1963 only if that obligation exists under the undertaking, because the registration statement was filed on or before the date of the enactment of the bill.

(b) If on January 1, 1965, B corporation has less than 300 shareholders of record of its common stock, but files a registration statement under the Securities Act of 1933 with respect to its common stock becoming effective on July 1, 1965, then as of July 1, 1965, B corporation will have an obligation to file in respect of all of 1965, regardless of the terms of the undertaking, the amount of its assets, or the number of holders of record of its common stock.

(c) If on January 1, 1966, B corporation has less than 300 shareholders of record of its common stock, but files a registration statement under the Securities Act of 1933, becoming effective on July 1, 1966, and relating to debentures with no conversion rights and with no warrants attached, then as of July 1, 1966, B corporation has an obligation to file in respect of all of the calendar year 1966. This results from the registration statement becoming effective in the year, even though that registration statement relates to securities that are not "equity securities," as defined in the Securities Exchange Act.

(d) If on January 1, 1967, there are less than 300 holders of record of the common stock and less than 300 holders of record of the debentures, B corporation will have no obligation to file in respect of the calendar year 1967; but if at any time during the year a registration statement under the Securities Act of 1933 becomes effective as to any of its securities, then as of such date B corporation will have a duty to file in respect of all of 1967. If on January 1, 1967, there are 300 or more holders of record of the common stock or of the debentures, or both, B corporation will have a duty to file in respect of all of 1967.

Whenever under section 15(d) there is a duty to file in respect of a period, filings would be required in respect of that period even though the actual filings are made during a period in respect of which the issuer has no duty to file. For example, a calendar year issuer required to file in respect of the calendar year 1964 would, after the end of that year, be required to file information, documents, and reports in respect of that year, even if the issuer is not required to file under section 15(d) in respect of periods after December 31, 1964.

The broad exemptive authority of new section 12(h) of the act would apply to companies subject to section 15(d). This would enable the Commission to adapt and modify the reporting requirements to meet the particular circumstances of different categories of issuers. Accordingly, the exemptive authority now contained in section 15(d) would be deleted.

Since the power of Congress directly to impose reporting obligations on issuers which offer securities through the use of the mails or other instrumentalities of interstate commerce is no longer open to question, the awkward requirement that every registration statement filed under the Securities Act contain an undertaking to file such reports as may be required by the Commission also would be deleted. This change would not affect undertakings becoming, or which have become, effective in connection with a registration statement filed on or before the date of enactment of the bill.

Section 8(a), amending section 16(a)—Controls over insider trading

Section 8(a) of the bill would amend section 16(a) of the exchange act to make the provisions of section 16 of the act applicable to officers and directors of issuers of equity securities registered pursuant to section 12 of the act and beneficial owners of more than 10 percent of any class of such securities. This would extend the insider trading provisions of that section to over-the-counter securities registered under new section 12(g) of the act.

Under the bill, section 16(a) of the act would require officers and directors of an issuer of equity securities registered pursuant to section 12 of the act and beneficial owners of more than 10 percent of any class of such securities to file with

the Commission reports of their holdings of, and transactions in, all equity securities of the issuer. Section 16(b) would provide for the recovery by, or on behalf of, the company of all profits realized by insiders from any combination of purchase and sale transactions in their company's equity securities within a 6-month period. Section 16(c) would prohibit insiders from engaging in the practices of "short selling" or "selling against the box" by making it unlawful for such persons to sell any equity security of the issuer if they do not own the security sold or, if owning the security, they do not deliver it, or deposit it for delivery, within the time limits specified in the statute.

Section 16(a) also would be amended so that the Commission would receive the originals of reports filed by insiders of all companies subject to the section. In the case of reports filed by insiders of listed companies, the appropriate exchange would receive duplicate originals, instead of originals as provided by existing law. Initial reports of holdings are now required to be filed at the time of registration on a national securities exchange and would be required upon the effective date of the registration statement pursuant to new section 12(g).

Section 8(b), amending section 16—Exemption for transactions by dealers making an over-the-counter market

Section 8(b) of the bill would amend section 16 of the Exchange Act by adding a new subsection (d). This subsection would provide that transactions by a securities dealer (including a dealer who is also a broker) who is subject to section 16 would be exempt from the profit recovery provisions of section 16(b), and the proscriptions of section 16(c), if such transactions are part of his ordinary trading activities in the company's securities and incident to the establishment or maintenance by him of a primary or second market for such securities. The exemption would not be available for transactions in securities which are, or at any time have been, held by the dealer in a segregated investment account. The Commission would have rulemaking power to prescribe the conditions under which securities would be deemed to be held in an investment account and under which transactions would be considered made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market. It would also have power to define each of these terms. It is the Commission's intention to issue regulations under section 16(d) by the date (late 1964) that section 16 will become applicable to insiders of issuers required to register under the new section 12(g)(1).

The exemption is limited to transactions by dealers in securities for which they are making an over-the-counter market.[6] Thus, at the time of the transaction, the dealer must have been indicating his willingness to other brokers and dealers to trade such securities on a regular basis for his own account at realistic prices. A dealer generally considered by other brokers or dealers having orders trade a security as the principal source or market for the execution of such orders is regarded as making the primary or principal market. Secondary markets are made by dealers who trade in a security regularly but on a more limited basis. A transaction by a dealer would not be exempt if incident to a market established or maintained by another dealer. If more than one dealer is making a market in a security at the same time, the marketmaking transactions of all such dealers would be exempt.

Transactions by a dealer, in order to be exempt, must also be "in the ordinary course of his business" and be "incident to the establishment or maintenance by him of a primary or secondary market." The "incident to" requirement means that the transaction must be a part of the dealer's activities in his establishing or maintaining a primary or secondary over-the-counter market. Thus, for example, in the case of a dealer making such a market for a security, sales to and purchases from other broker-dealers of that security would be "incident to" his establishment or maintenance of the market. The "ordinary course of his business" requirement in the main supplies reemphasis to several points implicit in the other parts of the section. It requires that there be some continuity and regularity in transactions; "one-shot" or sporadic transactions or series of transactions will not qualify. It also means that one facet of the dealer's business must be marketmaking in the security for which the exemption is claimed.

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[6] The Committee on Banking and Currency of the U.S. Senate made clarifying changes in S. 1642 to make this point clear. This accounts for the slight difference in language in sec. 8(b) between S. 1642 and H.R. 6789 and H.R. 6793.

In defining the term "investment account," it is the Commission's intention to lean heavily upon the analogies in the Federal income tax laws. In those laws, a fairly definite line has been drawn between investment (or capital) assets on one hand and assets held for sale to csutomers in the ordinary course of business on the other hand. For example, section 1236 of the Internal Revenue Code of 1954 establishes a conclusive presumption that no securities obtained by a dealer in securities are investment assets unless so earmarked within 30 days after acquisition.

In determining whether a dealer is the beneficial owner of more than 10 percent of a class of registered equity securities, both the securities in his trading and investment accounts would be counted.

Section 30(f) of the Investment Company Act of 1940 incorporates by reference the provisions of section 16 of the exchange act insofar as closed end investment companies are concerned. A broker-dealer making an over-the-counter market for the securities of such a company and who is also one of its officers or directors is now subject to the provisions of sections 16(b) and 16(c). His market-making transactions would be exempted by the new section 16(d).

Section 9, Amending Section 20(c)—Interference with the filing of required documents, reports, and information

Section 9 of the bill would amend section 20(c) of the exchange act to prohibit an officer or director of, or an owner of sceurities issued by, a company from hindering, delaying, or obstructing the preparation or filing of any report, document, or information required to be filed under the act. This section now applies only to filings by companies with sceurities registered on a national securities exchange or subject to the provisions of section 15(d) of the act. Since section 20(c), as amended, would apply to all filings heretofore or hereafter made under section 15(d), as amended, the specific reference to the undertakings required by section 15(d) would be deleted.

Section 10, repealing section 32(b)—civil penalties for failure to file reports required by section 15(d)

Section 10 of the bill would repeal section 32(b) of the Exchange Act, which provides for a penalty of $100 a day for failure to make filings pursuant to a section 15(d) undertaking. Enforcement of this provision has not been feasible. Because of this fact, because such undertakings would be discontinued for companies whose registration statements under the Securities Act are filed after the enactment of this bill, and because civil penalties are not imposed for failure to file information required by other provisions of the Exchange Act, this section would be repealed. Existing section 32(c) would be redesignated section 32(b).

Section 11, amending section 4(1) of the Securities Act of 1933—delivery of prospectuses

Section 11 of the bill would amend section 4(1) of the Securities Act of 1933 by adding a new sentence at the end of section 4(1). This would require all dealers to deliver prospectuses for a period of 90 days instead of 40 days after the commencement of the distribution in connection with transactions in registered securities of a company which had not previously sold securities pursuant to an effective registration statement. The amendment reflects a more realistic appraisal of the time frequently required for completion of the distribution of a new issue.

At present the third clause of section 4(1) exempts, subject to three exceptions, dealers from the requirement for delivery of prospectuses in connection with sales of securities which are publicly offered without or with registration under the Securities Act of 1933. The first exception relates to certain unregistered offerings. The second exception, in effect, requires that all dealers, whether or not formally members of the distributing group, deliver prospectuses in connection with transactions in any registered security for 40 days after the commencement of the distribution. The 40-day period was reduced from 1 year by statutory amendment in 1954. The third exception, in effect, requires delivery of a prospectus in transactions involving the dealer's allotment or subscription of the registered security during the entire period of the distribution by him. Only the second exception would be substantively affected by this amendment, but for the sake of clarity the three exceptions would be designated by letters (a), (b), and (c), respectively.

To permit greater flexibility in the administration of the requirement for delivery of prospectuses by dealers, both the second exception—clause (b)—

and the new last sentence of section 4(1) would provide that, in cases falling within the second exception, the Commission may shorten either the 40- or 90-day period for any security or class of securities. The Commission would be authorized so to act by rule, regulation, or order.

PART B—STRENGTHENING OF QUALIFICATIONS OF, AND CONTROLS OVER, THOSE IN THE SECURITIES BUSINESS AND STRENGTHENING OF SELF-REGULATION: SECTIONS 2, 6(A), 6(B), AND 7 AMENDING, RESPECTIVELY, SECTIONS 3(A), 15(A), 15(B), AND 15A OF THE SECURITIES EXCHANGE ACT OF 1934

Seceion 2, amending section 3(a)—Definitions

These new definitions would be added to section 3(a) in order to implement the subsequent changes. Paragraphs (18) and (21) would define the terms "person associated with a broker or dealer" and "person associated with a member" for convenience of reference in connection with the provisions for direct disciplinary action against individuals.

The definition in paragraph (18) would include exactly the same classes of persons now referred to in the fourth paragraph of section 15(b). Under existing law, an employee of a broker or a dealer is a person controlled by such broker or dealer. The statutory change to state expressly that an employee is a type of controlled person would be made solely to indicate on the face of the statute that this is the fact. Under paragraph (18), the Commission would be given the power, for the purposes of any portion or portions of the Securities Exchange Act of 1934, to classify controlled persons, including employees, by rules and regulations.

By rules and regulations, the Commission would be required appropriately (considering the public interest and the protection of investors with respect to matters such as access to customers' funds and securities) to exclude from paragraphs (1) and (2) of section 15(b) persons (other than employees dealing with the public) associated with a broker or dealer whose functions are clerical or ministerial. This would prevent the registration of a broker or dealer from being placed in jeopardy solely by reason of his employment of persons under some statutory disability in such ministerial capacities as doormen, elevator operators, clerks, stengographers, etc. The Commission would not, however, be under any obligation to exempt any persons or classes of persons from the new fourth paragraph of section 15(b)(1), which new paragraph relates to violations of the act where the mails or a means or instrumentality of interstate commerce are not used.

Paragraph (21) would provide a corresponding definition of persons associated with a member of a registered securities association. That definition would, however, include not only a person associated with a broker or dealer who is a member but a person who is registered with such an association. Thus, if an individual was discharged from employment by a member while proceedings against him were pending before the association, he would continue to be treated as a person associated with a member until his registration was terminated, which, under the rules of the association, would not occur until the proceedings against him had been completed. This would enable an association to retain jurisdiction, as the NASD presently does, over an employee registered with it, notwithstanding termination of his employment by a member.

Paragraphs (19) and (20) would define the terms "investment company," "insurance company," "affiliated person," "underwriter," and "investment adviser" because misconduct in, or with reference to, these organizations and capacities would become a basis for disciplinary action against brokers and dealers and persons associated with a broker or dealer.

Section 6(a), amending section 15(a)—required membership in a registered securities association; removal of intrastate exemption; power to exempt from registration

Section 15(a) presently prohibits a broker or a dealer (other than one whose business is exclusively intrastate) from using the mails or any means or instrumentality of interstate commerce to effect any over-the-counter transactions (other than in the types of securities enumerated in the statute) unless registered with the Commission. This section would be amended to prohibit a broker or a dealer (including one whose business is exclusively intrastate) from using the mails or any means or instrumentality of interstate commerce to effect any over-the-counter transactions (other than in the types of securities enumerated

in the statute) unless such broker or dealer is (a) registered with the Commission and (b) is a member of a securities association registered with the Commission pursuant to section 15A.

There would be a statutory exemption from the requirement of membership in a registered securities association for any broker or dealer during any period when either (i) there is no registered securities association, or (ii) the rules of each registered securities association preclude the membership therein of such broker or dealer solely because of the geographical location of, or type of business done by, such broker or dealer.

In addition, the Commission would be given power to exempt any broker or dealer from the requirement of membership in a registered securities association, either conditionally or unconditionally, where it deems this necessary or appropriate in the public interest or for the protection of investors. The Commission would consider using this exemptive power, for example, in the case of a broker or dealer who is a member of a national securities exchange or an exchange exempt from registration under section 5, if and so long as such broker or dealer does substantially all of his business on one or more such exchanges or in the case of a broker or dealer whose securities activities are wholly incidental to some other business such as the real estate business.

The Commission would also be given the power to exempt any broker or dealer from the requirement of registration with the Commission. The Commission sometimes finds borderline situations where it is not clear whether a firm is a broker or a dealer within the meaning of the statute, and the Commission could use such power to exempt, either conditionally or unconditionally, in those situations, if it found it necessary or appropriate in the public interest or for the protection of investors.

A broker or dealer whose entire business is transacted on a national securities exchange or whose business is exclusively in exempted securities, commercial paper, bankers' acceptances, or commercial bills (these being the securities enumerated in section 15(a)) would continue, as under present law, to be excluded from the requirements of section 15(a) so long as his business is so limited.

Section 6(b), amending section 15(b)

Section 15(b) would be amended in a number of respects. The format would be changed by dividing subsection (b) into three subdivisions—(b)(1), (b)(2), and (b)(3), all discussed below.

Section 15(b)(1)—Removal of requirement of showing use of Federal instrumentalities by registered brokers or dealers in proscribed acts

The provisions now contained in the first three paragraphs of present section 15(b), dealing with registration of broker-dealers, would be placed in renumbered subsection (b)(1); and in the first paragraph, the defined term "persons associated with such broker or dealer" would be inserted in place of the present longer statutory description of such persons now set forth. The defined term would cover the same classes of persons (except for the classification power in the Commission) presently covered in present section 15(b) and would be used solely as a convenient shorthand reference, because of the need for its use in several of the new sections. A similar change would be made in the second paragraph.

The proposed fourth paragraph of subsection 15(b)(1) is new and would specify that any provision (which would include any provision at any time enacted) of the Securities Exchange Act (other than 15(a) itself and section 5, which prohibits use of the mails or any means or instrumentality of interstate commerce to effect transactions on an exchange unless the exchange is registered) that prohibits any act or conduct if the mails or any means or instrumentality of interstate commerce are used in connection therewith, shall also prohibit such act or conduct by a registered broker or dealer or a person acting on behalf of such broker or dealer, whether or not the mails or any means of instrumentality of interstate commerce are used. This would, for example, obviate the necessity of proving the use of such instrumentalities in connection with a violation by a registered broker or dealer of the antifraud provisions of sections 10, 15(c)(1), and 15(c)(2), as well as the capital requirements of section 15(c)(3) of the Securities Exchange Act.

The term "person acting on behalf of a broker or a dealer" would include all persons associated with a broker or a dealer, and would also include any other person acting on behalf of a broker or a dealer. For example, an independent

contractor hired by a broker or a dealer would be a "person acting on behalf of a broker or a dealer" within the meaning of the statute, even if he were not deemed to be a "person associated with a broker or a dealer" as a controlled person of the broker or dealer.

Section 15 (b) (2)—First change—Addition of lesser sanctions of censure and suspension

The existing fourth paragraph of section 15(b), dealing with grounds for denial or revocation of registration of a broker or dealer, would become section 15(b)(2) and would be changed in three respects. First, the Commission would be given the discretion, in lieu of revocation of the registration of a broker or dealer, to impose the lesser sanctions of suspension of registration for a period not to exceed 12 months or formal censure. Neither is in existing law, although the Commission sometimes expresses its disapproval of conduct even though it does not impose a sanction. Censure would be more formal and would be considered a sanction.

Any such suspension could, in the discretion of the Commission, be lifted, modified, or shortened, for good cause shown, by the Commission before the stated expiration date of the suspension.

The Commission, particularly in the context of an offer of settlement, has upon occasion withheld the utlimate sanction of revocation or denial upon condition that the offending broker-dealer accept some lesser impediment. Authorization of the lesser sanctions of formal censure and suspension would permit the Commission, where appropriate, to impose those lesser sanctions directly without recourse to any process of negotiation, but would not limit or narrow the present procedures relating to conditional withholding of revocation or conditional granting of registration.

Section 15(b)(2)—Second change—Changes in grounds for denial or revocation of registration

The second change relates to the list of disqualifying grounds that permit the Commission to deny or revoke registration (or under the proposed amendments—to suspend registration for a period of up to 12 months or to issue a formal censure) upon a finding that it would be in the public interest to do so. As is the case under existing law, the existence of one of the statutory grounds of disqualification would lead to disciplinary action only if the Commission finds it in the public interest so to act.

This list would be expanded to parallel closely the list in section 203(d)(3) of the Investment Advisers Act of 1940, as that list was expanded in 1960. The list of disqualifying acts is contained in clauses (A) to (F).

In clause (A), there would be added the grounds of a willful filing with the Commission of a report required to be filed. A similar ground is contained in the Investment Advisers Act of 1940, as amended in 1960.

Clauses (B) and (C), dealing with criminal convictions and injunctions, would be broadened to incorporate a more complete list of financial crimes and offenses.

Clause (D) would be modified to make a violation of the Investment Advisers Act of 1940 and the Investment Company Act of 1940 (and rules and regulations under such statutes), as well as the Securities Act of 1933 and the Securities Exchange Act of 1934 (and rules and regulations under such statutes), a basis for disciplinary proceedings.

Clauses (B), (C), and (D), as so revised, would conform exactly with clauses (B), (C), and (D) of section 203(d)(3) of the Investment Advisers Act of 1940, as amended in 1960, except that proposed clause (D) of the Securities Exchange Act is slightly broader in that it includes violation of the Investment Company Act of 1940 and rules and regulations thereunder as grounds for disciplinary proceedings, whereas those grounds are not in the Investment Advisers Act.

Proposed clause (E) is new and would make willfully aiding, abetting, counseling, commanding, inducing, or procuring other persons in a violation of the enumerated Federal securities statutes (or rules or regulations thereunder), or failing reasonably to supervise such other persons who violate, a basis for proceedings. A person would not be willfully aiding, abetting, counseling, commanding, inducing, or procuring such a violation by such violating person if such person did not know, and did not have reasonable cause to know, of the acts, omissions, scheme, or plan of such violating person.

In a number of cases, the Commission has held that an individual participated in violations by a broker or dealer as an aider and abettor, and the proposed change in clause (E), which follows the language inserted in the Investment Advisers Act of 1960, would codify this practice and clarify the basis for it. With respect to failure to supervise, the Commission has consistently held that partners, branch managers, and other supervisory personnel of a broker or dealer firm have a responsibility to supervise employees and that revocation or other appropriate sanctions may be imposed upon a broker or dealer whose employees violate. The primary purpose of inserting failure to supervise as an independent ground of disciplinary action would be to enable the Commission to reach more directly supervisory personnel who fail to discharge their responsibilities. Such a supervisory person would, however, be responsible only if the employee who violated was subject to his supervisory jurisdiction. This amendment also provides that no person shall be deemed to have failed reasonably to supervise another person if appropriate supervisory procedures and system exist and the supervisory person involved has reasonably discharged his duties under those procedures and system and has no reasonable cause to believe that they were not being complied with. A supervisory employee is, therefore, not an absolute guarantor of the conduct of those whom he has the power to supervise. Thus, for example, if a branch manager has established appropriate procedures (and an appropriate system for applying them) for supervising the personnel of his office and appropriately discharges his own responsibilities without reasonable cause to believe that such procedures and system are not being followed, he is not responsible, even if, notwithstanding these precautions, one of his employees violates. Similarly, partners in the home office of a firm would not be responsible for violations in a branch office if appropriate supervisory procedures (and an appropriate system for applying them) for the branch office have been established and the partners have reasonably discharged their own duties and have no reason to believe that the established procedures and system were not being followed. It would, however, be the responsibility of managing partners to see to it that appropriate procedures and system are established and observed.

Proposed clause (E) would not limit the existing power of the Commission to discipline a broker or dealer firm for any violation by a person associated with such broker or dealer.

Proposed clause (E) follows clause (E) of section 203(d)(3) of the Investment Advisers Act of 1940, except that proposed clause (E) of the Securities Exchange Act is broader in two respects: (i) The Investment Company Act of 1940 is added to the enumerated Federal securities acts, and (ii) the ground of failure reasonably to supervise such other persons who violate is not expressly stated in clause (E) of section 203(d)(3) of the Investment Advisers Act of 1940. Also, the adverb "willfully" is not contained in the advisers act in relation to aiding, abetting, etc., but the knowledge element would be the same under both acts.

A new clause (F) would be added, which clause would make association with any broker or dealer by a person whose right to be associated with a broker or dealer has been barred or suspended under proposed section 15(b)(3), a ground for proceeding against such firm. Clause (F) has no exact counterpart in the Investment Advisers Act of 1940, since that act does not provide for the specific procedure of barring or suspending of the right of a person to be associated with an investment adviser.

In applying section 15(b)(2), it has been the Commission's policy that the registration of a broker-dealer will not be denied or revoked because of its employment of a person who is subject to a disqualification resulting from misconduct prior to employment, if (i) the broker-dealer has no knowledge of the disqualification, and (ii) the broker-dealer has used reasonable care in investigating and determining whether such person is subject to any of the statutory disqualifications. This same policy would be applied in administering the broadened grounds in section 15(b)(2), as proposed to be amended.

Section 15(b)(2)—Third change—Procedure in hearing on postponement of registration pending ultimate determination on denial

The third proposed change in section 15(b)(2) relates to the postponement of effectiveness of registration of a broker or dealer pending final determination in a denial proceeding. Under existing law, an application for registration by a broker or a dealer becomes effective 30 days after filing, unless the Commission

exercises its discretionary power to postpone effectiveness an additional 15 days. When the Commission has instituted a denial proceeding, that proceeding does not result in automatic postponement pending determination, and the Commission may postpone effectiveness until final determination only after notice and a trial-type hearing on the postponement question.

The existing law thus produces unnecessary complications. It would rarely be possible to conduct the necessary preliminary investigation, hold the hearing on ultimate denial, review the evidence, and write the opinion, all within 45 days. If this is not done, the application will become effective (unless the applicant consents to a postponement), and the question of denial will become moot. The only way in which this can be avoided is to hold a trial-type hearing on the question of postponement pending ultimate denial; and, for the reasons discussed above, it is likewise difficult to complete this within the 45-day period, and even where this is possible, unnecessary duplication of hearings results. Thus, as a practical matter, under present law, it is extremely difficult for the Commission to postpone registration (unless the applicant, as often occurs, consents to postponement of the effective date) simply because the necessary procedures cannot be completed prior to the time when registration becomes effective. If registration becomes effective, the Commission's only recourse is to start over and commence a revocation proceeding based upon the same grounds.

The proposed change would create a procedure, analogous to that utilized by the courts in granting a preliminary injunction for the similar purpose of preserving the status quo pending final decision, under which the Commission could, on the basis of affidavits and oral arguments, postpone the effectiveness of registration until final determination.

Proposed section 15(b)(3)—Authorizing proceedings by the Commission against individuals without joining a broker or a dealer

This new provision would authorize the Commission to proceed directly against a person and to censure, or bar (or suspend for a period not to exceed 12 months) the right of such person to be associated with a broker or dealer, if such person is subject to an injunction or conviction or has committed any act or omission which would be a basis for revocation or denial if such person were a broker or dealer, and if the Commission finds it in the public interest so to act. The existence of a statutory disqualification would, therefore, not automatically result in a censure, bar, or suspension.

Under this provision, the Commission would have the discretion to proceed against a person without joining a broker or dealer with whom such person or persons may be or may have been associated or, alternatively, in appropriate cases where an economy of proceedings would result, to join such a broker or dealer and other appropriate persons in the same action.

The Commission could proceed against and bar, suspend, or censure a person even though he has not been, and is not, associated with a broker or dealer. Such action would, among other things, warn the public and the broker-dealer community of violations.

A person barred or suspended could not, while such bar or suspension is in effect, register as a broker or a dealer, without the consent of the Commission, and, as under existing law, his association with any broker or dealer would be a basis for proceedings against that broker or dealer.

In such proceedings, all respondents would have the full due process protections now afforded brokers and dealers under existing law and would have a right of appeal to the appropriate Federal court of appeals, as specified in the Securities Exchange Act, in the event of adverse action by the Commission.

The last sentence of subsection (b)(3) would make it unlawful for any person against whom an order barring or suspending him has been entered and is in effect willfuly to become, or to be, without the consent of the Commission, associated with any broker or dealer and would make it unlawful for any broker or dealer, without the consent of the Commission, to allow such a person to become or remain associated with him, if such broker or dealer knew, or in the exercise of reasonable care, should have known, of such order. If this provision is violated, the Commission could proceed by obtaining an injunction against such person's continued employment by such broker or dealer, either in lieu of or in addition to disciplinary proceedings against the broker or dealer. In appropriate cases, criminal proceedings, in addition to the civil procedings, could be instituted.

In *Wallach* v. *S.E.C.*, 202 F. 2d 462, the Court of Appeals for the District of Columbia held that the Commission could not join persons associated with a broker or a dealer as parties to a proceeding dealing with the denial or revocation of registration of the broker or dealer without the consent of such persons; that court indicated, however, that the Commission's holdings as to whether such persons had violated any of the various Federal securities acts or suffered any other disability that would be grounds for denial or revocation of the registration of the broker or dealer would be res judicata as to such persons, even if they were not parties. The Commission's practice is to offer such persons the opportunity to become parties and to make findings in reference to such persons in any event. Proposed section 15(b)(3) would overrule the holding of Wallach that such persons cannot be joined by the Commission as parties, without their consent, to a proceeding involving denial or revocation of registration of a broker or dealer with whom they are associated—and, of course, proposed section 15(b)(3) goes much further than merely to overrule Wallach on that point.

Section 7(a)(1), amending section 15A(b)(3)—effect of exchange disciplinary action upon eligibility for membership in a registered securities association

The new clause added at the end of section 15A(b)(3) would authorize a registered securities association to adopt rules under which it might exclude from membership persons who had been suspended or expelled from a national securities exchange or who were excluded from association with all brokers or dealers who are members of such an exchange.

Section 15A(b)(4), and the rules adopted by the National Association of Securities Dealers thereunder, require the exclusion from membership of brokers and dealers who have been suspended or expelled by an exchange for violation of a rule of the exchange which prohibits conduct inconsistent with just and equitable principles of trade. In some cases, however, it may be difficult to determine, in the absence of an express finding by the exchange (which finding, under exchange procedures, often is not made), whether or not a particular rule under which an exchange has acted is within this category. The proposed new provision will permit a registered securities association to have rules to resolve this problem, which has been a source of concern to the NASD and to the New York Stock Exchange.

The rules to be adopted by an association thereunder would require the approval of the Commission. The Commission anticipates that such rules would not bar a person from becoming a member of a registered securities association because of an exchange suspension or expulsion, unless the grounds for the suspension or expulsion involved serious misconduct of a nature affecting the public interest and the protection of investors. Such rules would also empower the association to determine the basis for the suspension or expulsion if this was not clear from the exchange's action and would entitle the person to a hearing if he claimed that he had not received a fair hearing before the exchange. In addition, the Commission would have power to direct an association to admit a person notwithstanding disciplinary action by an exchange, and the Commission would expect to consider and pass upon any request that it so direct from a person who alleged either that the grounds upon which the exchange had acted did not justify his exclusion from the association or that he had not received a fair hearing by the exchange.

Section 7(a)(2), amending section 15A(b)(4)—Reflecting expansion of powers of registered securities associations to proceed against individuals

This paragraph, which enumerates statutory disqualifications that will bar a broker or dealer from membership in a national securities association, absent approval of the Commission, would be amended to reflect the greater express power which would be given the Commission and registered securities associations in sections 15(b) and 15A to discipline persons associated with a broker or dealer and persons associated with a member. There would also be added a new clause at the end of paragraph (4), which clause would expressly confer upon the Commission, an exchange, or a registered securities association, jurisdiction to determine whether an individual is the cause of disciplinary action taken by them against a broker or a dealer. Under existing law, the making of such a finding by an association or exchange bars association with a member, and it should be expressly provided that an association and an exchange have the authority to make the finding the statute impliedly requires.

S. 1642, but not the other bills, would amend the act expressly to provide that a broker-dealer firm will not be barred from membership in a registered securities association because a person associated, or formerly associated, with it is subject to one of the statutory bars of section 15A(b)(4) unless it can also be shown that, while such person was associated with the firm, the firm knew or in the exercise of reasonable care should have known of the disability. This is intended to deal with the situation where a broker-dealer firm employs a person who is subject to a disqualification resulting from misconduct prior to employment and the firm (i) had no knowledge of the disqualification, and (ii) used reasonable care in investigating to determine whether the employee was subject to a disqualification.

Section 7(a)(3), amending section 15(b)(5)—Addition of requirement that a registered securities association have specified and appropriate rules relating to training, experience, and other qualifications of members and persons associated with members and to members' capital

Subsection (b) of section 15A, which subsection specifies the requirements which an association must meet in order to be registered as a national securities association, would be modified by renumbering the existing paragraph (5) as paragraph (6), by similarly renumbering the following paragraphs, and by adding a new paragraph (5).

While the National Association of Securities Dealers, acting under section 15A(b)(3) and other provisions of the act, has adopted certain rules requiring examinations by new salesmen, and specifying other standards, these controls have not been comprehensive. Section 15A(b)(5) is designed to carry out one of the most important recommendations of the Special Study in an area that has long been of concern to the Commission. The proposed new paragraph (5) would require the association to adopt specified and appropriate standards with respect to the training, experience, and other qualifications of members and persons associated with members, and for that purpose appropriately to classify prospective members and other persons, specify the standards that shall be applicable to any such class, require persons in appropriate classifications to pass examinations, and to identify those classes of persons (which would not include prospective members, partners, officers, and supervisory employees) who might be qualified solely upon the basis of training and other qualifications. Thus, it is contemplated that members, officers, partners, and other supervisory employees might be required to meet standards of experience as well as training. This subsection would also expressly authorize an association to require any class of persons associated with a member to become registered with it and to require that applications to become a member or to be associated with a member set forth such information as the association might require and would provide that such applications shall, for the purposes of section 32(a) of the Securities Exchange Act, be deemed applications required to be filed under the Securities Exchange Act. This would mean that persons filing a false application with a registered securities association would be subject to the penalties provided by law for filing a false statement under the statute.

Under the proposed amendment, an association could not prescribe qualifications for persons associated with a member unless such persons were natural persons. This would mean, for example, that an association could not prescribe qualifications such as training, experience, and capital for a nonmember corporation or partnership acting as investment adviser to an investment company, or for an investment company itself, even if such investment adviser or investment company controlled or was controlled by a member of the association which acted as underwriter for the investment company. Neither this paragraph nor the use of the words "natural persons" in the amendment to section 15A(k)(2) would in any way limit the provisions of sections 15A(b)(4) and 15A(b)(3), so that, for example, any disqualifications applicable to a partnership or to a corporation controlling or controlled by a member would still be a basis for exclusion of the member from membership.

In establishing qualifications and making classifications pursuant to the subsection, it is anticipated that the NASD or any other existing registered securities association would, as it could, adopt appropriate "grandfather" clauses exempting, in whole or in part, existing members or persons associated with present members, either permanently or for a transition period, from some or all of the qualifications required of new entrants. It is also anticipated that all registered securities associations would, as they could, also make similar or identical exemptions for (1) new members admitted to membership before

July 1, 1964 (the effective date of the new requirement of compulsory membership in a registered securities association), and (2) persons associated with such new members on the date of their admission.

Another important change contained in the subsection would authorize an association to establish standards of financial responsibility for members. A 1942 Commission opinion cast doubt on the power of a registered securities association to impose requirements relating to members' capital and the proposed amendment would eliminate that doubt.

Under its power to classify, an association could distinguish between members upon the basis of the type of business done and the nature of securities sold. Thus, for example, appropriate requirements with reference to capital and other qualifications could be provided for, on the one hand, members who engage in the underwriting of new issues and, on the other hand, members who limit their activities to the sale of investment company shares.

Any rules adopted by an association under this new subsection (b)(5) would, of course, have to be approved by the Commission as required by existing section 15A(j). In addition, under section 15A(k) as proposed to be amended, the Commission would have express authority to require an association to alter, modify or supplement its rules with respect to the qualifications of members and persons associated with members.

Section 7(a)(4), amending section 15A(b)(9)—Requirement of rules requiring discipline of persons associated with a member

Paragraph (9) [now paragraph (8)] of section 15A(b) presently requires that the rules of a registered securities association provide that its members shall be appropriately disciplined for any violation of its rules. The NASD has, in addition, adopted rules providing for disciplinary proceedings against registered representatives of members, but only in connection with proceedings against members.

Paragraph (9) would be amended by providing that the rules of a registered securities association must provide that "persons associated with its members" (a term more inclusive than the NASD's present "registered representative" classification) shall be appropriately disciplined, by expulsion, suspension, fine, censure, or by being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules.

It would be contemplated that the rules of each registered securities association would allow, among other things, disciplinary proceedings, in its discretion, against individuals, without joining members.

Section 7(a)(5), amending section 15A(b)(10)—Requirement of procedural safeguards in disciplinary proceedings against persons associated with members

Paragraph (10) [now paragraph (9)] of section 15A(b) would be amended to refer specifically to disciplinary proceedings against persons associated with members and to require that all the safeguards now specified in that paragraph relating to disciplinary proceedings against members be applicable to proceedings against persons associated with a member. The rules of the NASD presently provide such safeguards, and the sole effect of this amendment would be to make such safeguards for persons associated with a member mandatory for the NASD and for all registered securities associations.

Section 7(a)(6), adding first new unnumbered paragraph at the end of section 15A(b)—Explicit requirement that an association have rules with reference to quotations

At the present time, the National Association of Securities Dealers concerns itself actively with quotations for securities in the over-the-counter market, particularly retail quotations. It however has only a limited number of rules which deal with quotations and much of its activity is conducted without the benefit of specific rules. The proposed amendment would not only expressly authorize all registered securities associations to have such rules, but would require that such rules exist and would specify that they be designed to produce fair and informative quotations and to prevent fictitious and misleading quotations as well as to promote orderly procedures for collecting and publishing such quotations. This amendment is not intended to be a resolution of the substantive problems with respect to quotations, which problems are discussed in chapter VII of the Report of the Special Study of Securities Markets. As stated, the purpose of this amendment is to clarify the authority of registered securi-

ties associations in this area and impose upon them an obligation to act. The standard for action—to prevent fictitious quotations and to promote fair and informative quotations—is essentially similar to that underlying the Commission's broad authority over the quotation activities of brokers and dealers under subsection 15(c)(2) of the Securities Exchange Act. Resolution of the substantive problems dealing with quotations will await further consideration of the Study Report and consultation with the industry. This resolution may take the form of a Commission rule, action by registered securities associations, and/or the submission to the Congress of a statute to regulate the activities of persons who publish quotations.

There are a number of other areas in which the study and the Commission have suggested, or will suggest, action by the NASD, which has a history of acting to effect needed improvements after conferences and discussions between the Commission and it. These areas include practices in connection with the solicitation of business, the dissemination of investment advice, and the distribution of securities, as well as trading in securities which are the subject of such distributions. The Commission believes, however, that under present section 15A(b)(7) and elsewhere an express authorization of new powers for registered securities associations is not necessary.

The powers of the Commission concerning registered securities associations and the over-the-counter markets are also relevant in this regard. The Commission has power to abrogate any rule of an association and to disapprove any new rule proposed by an association. While the Commission can alter or supplement the rules of an association relating to the organization and operation of an association as such, it has no power to alter or supplement (as opposed to abrogation or disapproval of) substantive rules of an association. The Commission, however, has ocnsiderable direct rulemaking power, to a significant extent never exercised, concerning the over-the-counter markets under section 15(c)(2) and other provisions of the Exchange Act. The Commission expects to exercise these powers to the extent necessary. If the direct powers are found wanting in any respect, the Commission will request Congress either to strengthen its direct rulemaking powers or to empower the Commission to alter or supplement the substantive rules of registered securities associations.

Section 7(a)(6), adding a new paragraph at the end of section 15A(b)—Date on which existing associations must conform their rules to meet new requirements

This new unnumbered paragraph specifies that existing registered securities associations, in practice the NASD, must, by July 1, 1964,[7] amend their rules to conform to the additional requirements that would be added to section 15A(b). If the rules of such an association do not so conform by that date, the registration of the association could be suspended by order of the Commission—but only after notice and hearing, and a determination that the rules do not so conform. Any such suspension would remain in effect until the Commission issues an order determining that such rules have been modified to conform with the requirements of section 15A(b) as amended.

Section 7(b), amending section 15A(d)(2)—Technical conforming amendment

This is a conforming amendment that will amend section 15A(d)(2), which deals with the qualification requirements of a securities association desiring to become affiliated with a registered national securities association (at present there are no such affiliated associations), to conform the cross references therein to the amendments to section 15A(b).

Section 7(c), amending section 15A(g)—Commission's power to review disciplinary proceedings of an association—Stays pending Commission determination on review

Three changes are made in this section. First, the section would be amended to provide expressly that disciplinary action taken by a registered securities associaton against a person associated with a member will be reviewable by the Commission. The law presently provides that the Commission has such power to review disciplinary action against a member, and since, at present, the NASD proceeds against persons associated with a member only as a part of a proceeding against a member, the Commission presently reviews NASD actions involving

[7] This date is contained in S. 1642. In the other two bills, the date is left blank.

persons associated with members if the aggrieved person makes application for review or if the Commission institutes review on its own motion. The change would make it clear that the Commission would review, either on its own motion or the motion of an aggrieved party, disciplinary action by the NASD or any registered securities association against a person associated with a member in a proceeding where no member is involved; this change is necessary because the proposed amendment to present paragraph (8) of section 15A(b) would authorize a registered securities association to adopt a rule allowing it to proceed against a person associated with a member without joining a member. The change would also make it clear that when a registered securities association bars any person from being associated with a member (e.g., by ordering that a member cannot employ a certain person as a salesman because of some alleged statutory bar), such action will be reviewed by the Commission if the aggrieved person makes application for review or if the Commission institutes review on its own motion.

Second change.—The second change in this section would shorten the period in which an aggrieved member, person associated with a member, or person seeking to become a person associated with a member, may apply for review by the Commission of the specified types of action by a registered securities association. The change would shorten that period from "60 days * * * or within such longer period as the Commission may determine" to "30 days * * * or within such longer period as the Commission may determine." This would expedite review and yet leave ample time for aggrieved persons to make application for review.

Third change.—The third change relates to stays of action by a registered securities association pending final Commission determination upon review. Under present law, application to the Commission for review automatically, and in all cases, stays the action taken by the association. In a few cases, this is undesirable. For example, if a member is expelled by the NASD for fraudulent conduct, an application for review to the Commission automatically stays the expulsion and there is no procedure whereby the Commission can order otherwise, even though it appears clear the NASD's action will be upheld by the Commission on review. In effect, such a broker-dealer is patently buying time pending the expected Commission decision upholding the NASD action. Under the proposed change, the Commission would be empowered, after notice and opportunity for hearing on the question of the stay, to order that there will be no stay of the action of a registered securities association pending the Commission's ultimate decision on review. The Commission could, in its discretion, order that the hearing on the question of the stay be limited to affidavits and oral arguments. The Commission could order a hearing on the question of a stay either on its own motion or upon application of the registered securities association. Any such application for hearing on the question of a stay could be acted upon summarily, and without notice, by the Commission. The denial of an application by the registered securities association for a hearing on the question of a stay would, of course, not be appealable by the association. Also, if a hearing on the question of a stay is ordered, and if the Commission finds that there should be a stay pending final determination, neither the association nor any other person could appeal that finding. In any such proceeding concerning the question of a stay, the Commission could order that there be no stay only if it found to be necessary or appropriate in the public interest or for the protection of investors so to order.

Section 7(d), amending section 15A(h)—Procedure in Commission review of disciplinary action and denial of membership by a registered securities association

Section 15A(h) specifies the procedure and the Commissions' authority in reviewing disciplinary action by an association against members and in reviewing association action in denying membership. The proposed amendment would make those procedures and that authority also applicable to Commission review of disciplinary action against persons associated with members and to the barring by an association of any person from being associated with a member.

In view of the proposal to make membership in a registered securities association compulsory, the extent of the Commission authority to review disciplinary action by an association, particularly denials of membership and expulsion from membership, becomes particularly significant. Under existing section 15A(g) any person aggrieved by any such action may appeal to the Commission as of right and any decision by the Commission upon such an appeal is subject to

further review in the appropriate U.S. court of appeals. In the case of any appeal from disciplinary action by an association against a member, the Commission is required by existing section 15A(h)(1) to set aside the action of the association unless it finds, after appropriate notice and opportunity for hearing, upon consideration of the record, that the member has engaged in the acts, practices, or omissions constituting a violation of such rules of the association as were alleged by it to have been violated. Even if these findings are made, section 15A(h)(2) provides that if the Commission finds that the penalty imposed upon the member is oppressive or excessive, it shall cancel, reduce, or require the remission of such penalty. It has been the consistent construction of the Commission that it is required to pass upon the question of whether or not any penalty is excessive or oppressive, and to make the determinations called for by this subsection, if the issue is raised by a person appealing to it.

In addition, section 15A(b)(4) provides that expulsion from an association constitutes a bar to future admission to membership only if the expulsion was for violation of a rule of the association which prohibits conduct inconsistent with just and equitable principles of trade, and the Commission is required by section 15A(h), in any appeal from a disciplinary proceeding, to determine whether or not the conduct prohibited by the rule upon which the association relies is inconsistent with just and equitable principles of trade. It has therefore been the consistent administrative construction of the Commission and the NASD that an expulsion of a member for violation of a rule of the association operates as a bar to his readmission only if the rule in question is one which prohibits conduct inconsistent with just and equitable principles of trade.

The Commission knows of no case, other than those involving nonpayment of dues or fines, in which the NASD has expelled or suspended a member without finding that his conduct was inconsistent with just and equitable principles of trade.

Section 7(e), amending section 15A(k)(2)—Expansion of Commission's power to alter or supplement rules of registered securities associations relating to organization, discipline, and eligibility for membership

Section 15A(k)(2) now authorizes the Commission to require the alteration or supplementation of the rules of an association with respect to four enumerated matters, including organization, discipline, and eligibility for membership.

It is proposed that subdivision (A) of section 15A(k)(2) be amended to add the following to the areas in which the Commission can alter or supplement the rules of a registered securities association: Basis for and procedure in connection with the barring from being associated with a member, the disciplining of persons associated with a member, and the qualifications (which would include training, experience, and integrity) required for members, or "natural" [8] persons associated with members or any class of either. The Commission is proposing amendments to section 15A relating to discipline and qualifications for membership, and the proposed amendment to subdivision (A) of section 15A(k)(2) would be needed to insure that the Commission retains ultimate control in these areas, consistent with the philosophy of the Maloney Act.

Under the proposed amendment, the Commission would, of course, have full power to alter or supplement the rules of a registered securities association in the areas covered by the proposed new paragraph (5) of section 15A(b), including the area of members' capital and the financial responsibility of members.

In addition, the introductory portion of section 15A(k)(2) would be amended to clear up a technical procedural ambiguity. Under the procedures of present law, the Commission makes written request of an association to adopt a specified alteration or supplement to its rules. If the association fails within a reasonable time to adopt such alteration or supplement, the Commission may, by order, alter or supplement the rules of the association in the manner theretofore requested, if after notice and opportunity for hearing, it appears to the Commission that such

[8] S. 1642 is slightly different from the other two bills in the language used in amending subdivision (A) of sec. 15A(k)(2). Each of the three bills, in identical language, makes it clear in the proposed new sec. 15A(b)(5) that a registered securities association is not to prescribe qualifications for nonmember investment companies and investment adviser corporations or partnerships controlling or controlled by a member. This is done in the proposed new sec. 15A(b)(5) by limiting an association's powers to prescribe qualifications for persons associated with a member to "natural" persons associated with a member. S. 1642, but not the other bills, reemphasizes that limitation in the proposed amendment to subdivision (A) of sec. 15A(k)(2) by the use of the word "natural" before "persons associated with." See, however, the analysis of sec. 7(a)(3) of the bill for the effect of the use of this word in relation to secs. 15A(b)(3) and 15A(b)(4) of the act.

alteration or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of section 15A. Under existing law, it is unclear whether the alteration or supplement ordered to be adopted must be the exact one submitted to the association before the opportunity for hearing. This is an unfortunate ambiguity, for the hearing (or written comments submitted outside of a hearing) may show that the alteration or supplement first submitted should be modified. The proposed amendment would make it clear that the Commission can modify the alteration or supplement first requested (after notice and opportunity for hearing on such alteration or supplement) and that the modified alteration or supplement can be ordered adopted, without further notice and opportunity for hearing.

Section 7(f), amending section 15A(1)(2)—giving the Commission power to suspend or bar a person from being associated with a member of a registered securities association

The Commission presently has authority to suspend or expel a member of a registered securities association for a violation of the Securities Act of 1933 or the Securities Exchange Act of 1934 (or rules or regulations thereunder). This amendment would give the Commission express authority to suspend (for a period not to exceed 12 months) or bar an individual from being associated with a member, on the same grounds that a member may be suspended or expelled by the Commission. This is a part of the overall proposal that the Commission be given authority to proceed against individuals as well as firms and is a correlative of proposed section 15(b)(3) giving the Commission power to bar or suspend a person from being associated with a broker or a dealer. Of course, an individual who is a respondent in a proceeding under this provision would be entitled to the same due process protections as members presently have, including a right of appeal to the appropriate Federal Court of Appeals, as specified in the Securities Exchange Act, if the Commission makes an adverse determination.

As would be true under proposed section 15(b)(3), the Commission would have discretion concerning joinder or nonjoinder of individuals with brokers or dealers or other persons, and could proceed against persons who are not, and have not been, associated with a broker or dealer or member.

PART C, SECTION 12, EFFECTIVE DATE PROVISIONS

Section 12 provides that, with three exceptions, all amendments contained in the bill shall be effective upon enactment.

The first exception is that the new section 12(g)(1) of the Exchange Act, which would be added by section 3(c) of the bill and which would require certain over-the-counter issuers to register their equity securities, would become effective on July 1, 1964.

The second exception is that the amendments to section 15(a) of the Exchange Act, contained in section 6(a) of the bill, would become effective on July 1, 1964. These amendments relate to required membership of over-the-counter brokers and dealers in a registered securities association and to removal of the exemption from registration with the Commission for over-the-counter brokers and dealers who use the mails or facilities of interstate commerce to conduct their business but whose business is "exclusively intrastate." This will allow affected brokers and dealers sufficient time to comply with these new requirements.

The third exception is that the amendment to section 12(b) of the Exchange Act, contained in section 3(a) of the bill, would also become effective on July 1, 1964. The amendment to section 12(b) of the act relates to the filing of material contracts not made in the ordinary course of business by issuers with a security registered under section 12 of the Exchange Act. In S. 1642 as introduced, and in the other two bills, the amendment to section 12(b) of the act would be effective upon enactment. The Committee on Banking and Currency of the U.S. Senate inserted the July 1, 1964, effective date in S. 1642 so that issuers with a security listed on a national securities exchange would not be discriminated against in relation to over-the-counter issuers, who would not be required to file such contracts before July 1, 1964, in any event because the new section 12(g)(1), the registration provision relating to over-the-counter issuers, first becomes effective on that date.

Section 12(3) of S. 1642 is identical with section 12(4) of the other two bills. The Committee on Banking and Currency of the U.S. Senate deleted the third paragraph of section 12 of S. 1642 as introduced and renumbered

the fourth paragraph as paragraph (3). The removed third paragraph related to the effective date of the amendments to section 15(d), contained in section 6(d) of the bill, and was considered by that committee to be inconsistent with the provisions of the amendments to section 15(d).

Mr. STAGGERS. Does this conclude all the things that need to go into the record?

Mr. CARY. Yes; I believe so.

Mr. STAGGERS. Mr. Chairman, there are several other statements that have not been alluded to. The "Price Fluctuation and Available Data For Evaluation of Selected Insurance Company Stocks" is one of those that I refer to.

Mr. CARY. I think that we developed in the last few days, sir. I was going to introduce it in the event there were questions and discussions on insurance company problems, but I think perhaps it is just as well to put it into the record at this time. It is an analysis made by our staff in recent times which demonstrates the very wide fluctuation in a sample group of insurance company stocks which are presently not listed on any exchange.

This wide fluctuation demonstrates that insurance stocks are no more stable, indeed perhaps less stable, than many other types of stocks of other companies.

I would like to have that made a part of the record.

Mr. HARRIS. What we are trying to do, Mr. Cary, is to get all of this information in the record and get it as clearly as we can, so it will be easier to discover and, therefore, be easier for reference. I wondered if it would not be more appropriate if that statement, Mr. Chairman, could be included with the statement you read this morning, wherein you discussed insurance.

Mr. CARY. I think you are absolutely right, Mr. Chairman. That would, therefore, be at the end of the discussion which begins at page 27 and ends at page 38 of my statement this morning. That is the total discussion on insurance companies.

Mr. HARRIS. I believe it would be appropriate if it could be included at that point in the record.

Mr. CARY. I think you are right. I am sorry I didn't do that this morning.

Mr. STAGGERS. That will be so ordered.

(The document referred to appears on p. 90.)

Mr. STAGGERS. Was this information that you have testified to here given to the Senate in their hearings?

Mr. CARY. It was not. Some of the gentlemen and the staff have worked on this, but it was given to me yesterday. I thought it was of sufficient interest to be part of the record.

Mr. STAGGERS. Then it is new material, totally?

Mr. CARY. It is new material; that is correct, sir.

Mr. STAGGERS. Might I ask, then, in relation to most of these other items that you have, if they are new material, too, which have been worked up?

Mr. CARY. I would say, for example, the statement that I made this morning is not by any means totally new material because I was relating myself to the same issues in the bill. It is much expanded by reason of our appearance before the Senate. That is likewise true with respect to the justifications, Mr. Chairman.

The material, of course, this afternoon, is totally new. The discussion we had before the Senate focused exclusively on the bill.

Mr. STAGGERS. And for the reason that you did have the hearing, much new material has come to light and you are developing it much more fully?

Mr. CARY. That is correct.

Mr. STAGGERS. And it will be much more material to digest by this committee, and to go into it and evaluate it.

Mr. CARY. We attempted, if one calls the first statement this morning a good synopsis, to distill it into that statement, primarily.

Mr. STAGGERS. I would ask you this: You would expect this committee to digest what you have given them and to evaluate it, would you not?

Mr. CARY. Yes, sir.

Mr. STAGGERS. I don't think we can do that overnight.

I have two questions I would like to ask before passing on just as preliminary matters. I note that in your transmittal letter covering part 1, you state that while serious shortcomings are apparent, there is not a picture of pervasive fraudulent activity, and, thus, the situation is different from the situation of 30 years ago.

Is it your opinion that on balance, or is it your opinion that overwhelmingly, the rules of the exchanges and the securities associations are adquate today for the protection of investors?

Mr. CARY. Mr. Chairman, my answer to that can be only that there are many suggestions made by the Special Study with respect to changes in those rules, and if those changes are made pursuant to the recommendations, after we have thought them through and discussed them with the industry, then it would be our opinion that they are generally adequate.

Mr. STAGGERS. Then the Special Study covered the rules of the exchanges and the securities associations, including rules for discipline, for conduct inconsistent with just and equitable principles of trade, quoting you.

Mr. CARY. That is right; yes.

Mr. STAGGERS. As you know, these last words are words of art and are defined in the Exchange Act to mean any violation of the Exchange Act or any rule or regulation issued thereunder. Thus, the Special Study, in effect, incorporated a study of the rules of the Commission.

Therefore, I wish to ask you to express your opinion in a few words on this question: Are the rules of the Commission adequate today for the protection of the investors?

Mr. CARY. By the same token, Mr. Chairman, the Special Study has made a number of recommendations which are not only for amendment of the rules of the various associations, that is, the NASD and the exchanges, but also the rules of the Commission. If we go ahead, as we are working now, as I indicated in our implementation, if we go ahead and proceed to make those amendments, then it would be our opinion that on the basis of that study, in our view they are generally adequate. I don't say that we are not going to be, over a period of years, not keeping looking, and, indeed, that is what our Office of Program Planning will be for, to make sure that we keep up with the times. But by and large the answer is "yes."

Mr. STAGGERS. We will go into that a little more fully a little later. I would like to get into these different recommendations that have been made by the committee.

Mr. Chairman, we have your legislative recommendations before us which grow out of the Special Study. I understand that you may have some further recommendations coming from your study of the effect of the *Silver* case, which has been mentioned, on self-regulation.

Mr. CARY. We mentioned that there might be a possibility of that. We are not sure at this particular time whether or not we will find it necessary. It is a matter that we are considering and, of course, we have been discussing the implications of the *Silver* case with the exchange.

Mr. STAGGERS. And a study of the investment companies, too?

Mr. CARY. In the investment companies it could conceivably be. Once we get the recommendations from the Division and from the studies that are presently in process, it could conceivably be that we might be here for legislation. I cannot speak to that as far as actually knowing at this moment.

Mr. STAGGERS. I was going to further ask if you thought this would be all the legislation you need to protect investors, this that you have proposed to us in this?

Mr. CARY. This is all we have in the immediate future. Certainly, as I say, none this year. We have in mind at this moment no concrete program for next year. In other words, this is all we have, really, available and actually concretely in our planning at this time.

Mr. STAGGERS. What I am trying to get at is this: If we enact this, and maybe we have some amendments, then you can assure us in your words, for the Commission, the American investor will be protected?

Mr. CARY. We will do the best we can. I think we believe that these recommendations that we have made will be a substantial move toward that protection, and I will say that this is the best effort we can make to achieve that protection.

Mr. STAGGERS. The committee, of course, will work over those, and I guess will give their wisdom on it, too.

Mr. Harris?

Mr. HARRIS. No questions at this time, Mr. Chairman.

Mr. STAGGERS. Mr. Dingell?

Mr. DINGELL. Thank you, Mr. Chairman.

Mr. Cary, I want to commend you for a very fine statement and one which I think does a great deal toward setting forth the need for this legislation.

Mr. Chairman, I have several questions I would like to ask you. I would like to ask you first with regard to section 3(c) of H.R. 6789, I would like to refer you to that section in connection with a particular happening which occurred recently. I am sure you are familiar with the articles that have been appearing in the paper about Mortgage Guaranty Insurance Co.?

Mr. CARY. Yes, sir.

Mr. DINGELL. The question is: Would registration of companies having securities traded in the over the counter include banks and insurance companies such as the Mortgage Insurance Co.?

Mr. CARY. Yes; it would include companies such as the Mortgage Guaranty Insurance Co. I would have to know how many share-

holders it has at the present time, but I am lead to believe, or I am told that it would include it. In other words, it has enough shareholders to qualify in this category. Indeed, it is a good example of the kind of situation where we need this kind of legislation on a future basis for this type of company.

Mr. DINGELL. This would require the Mortgage Guaranty Insurance Co. to file certain information with you?

Mr. CARY. Curent information; that is correct.

Mr. DINGELL. And, also, to make available proxy statements?

Mr. CARY. That is correct. And it would also be subject to insider trading provisions.

Mr. DINGELL. Did the company register with you under the 1933 act?

Mr. CARY. It did register with us under the 1933 act, I think, on at least two or three occasions.

Mr. DINGELL. Is it possible it may have filed a Regulation A prospectus in lieu of such filing?

Mr. CARY. I think on getting more into detail about that, I would like to ask my colleagues, Commissioner Woodside and Commissioner Cohen, who were both Directors of that Division, who may have a little more detailed knowledge of that than I.

Mr. WOODSIDE. Mr. Chairman, Mortgage Guaranty, I believe, did not file anything with us under Regulation A. It has filed three registration statements, the first in the latter part of 1959, and then there was one in 1962, and a third one this year.

Mr. DINGELL. Has this company, the Mortgage Guaranty Insurance Co., supplied the SEC with periodic reports as required by section 15(d) of the Exchange Act of 1934?

Mr. CARY. It is my understanding that the company is current on its reporting requirements.

Mr. DINGELL. Thank you, sir.

There are several questions I would like to ask, Mr. Chairman, with regard to the commingled funds which would occur, for example, through banking activity. I understand the Commission has claimed the security laws are applicable to certain bank activities in the area of commingled funds.

Precisely what activities do you feel create the problem here of commingled funds?

Mr. CARY. In that connection, sir, the banks are now contemplating the creation of a pool of securities and encouraging the public to invest in them.

I would like to give you the background, if I may, of one type of commingled funds which the banks are seeking to create.

In the past, as you may know, they have been offering—as an investment adviser—investment advice to individuals. Now the banks would like to handle smaller accounts, and this apparently can be done economically only if they commingle the assets in each individual account.

They propose to do precisely what the investment counselor did back in the 1930's, and what the Congress in 1940 determined to be a mutual fund subject to the Investment Company Act. In other words, in fact, one of the very origins of investment companies in this country arose from the fact that investment counselors, who could not afford

to counsel people with a limited amount of funds, finally decided that they would just have to organize an investment company in order to, you might say, pool the funds of a variety of people and as to which they; that is, the investment counselor, would be the investment adviser for a fee.

A precise counterpart of this is taking place with respect to banks. That is their proposal, that they would form a pool in which participants would transfer their funds and the bank would act as investment adviser to it.

In that case, by the way, and we are getting into a proposal that I believe at some point may be before this committee, we would feel that the protection which is afforded to investors, in these investment counselor-sponsored mutual funds should be equally applicable to investors in the proposed bank-sponsored mutual funds.

Mr. DINGELL. Has this been permitted for banks to engage in this activity over the years?

Mr. CARY. They have not had that power up to this time.

If I could, I would like to give you a little of the history of the background of that.

They were actually prohibited from commingling funds during the 25 years that the Federal Reserve bank had jurisdiction over their activities.

The Federal Reserve Board was particularly sensitive to the problem of the banks entering into the securities business. I think this sensitivity was particularly apparent in another area of commingled funds, which is the so-called common trust fund. That is a narrower situation dealing only with trusts over which the bank, itself, has responsibility.

The Federal Reserve Board had, from the beginning, carefully restricted the use to which common trust funds could be put by permitting only the assets of trusts set up for bona fide fiduciary purposes to be commingled in such common trust funds.

The Board, in a 1940 issue of the Federal Reserve Bulletin, explained that the purpose of this prohibition was that trust guides or forms should not be used to enable a trust institution to operate a common trust fund as an investment trust attracting money seeking investment alone, and to embark upon what would be, in effect, the sale of participations in a common trust fund to the public as investment.

So, what actually happened was this regulation formerly under the supervision of the Federal Reserve Board being shifted over to the Comptroller of the Currency and at that point he deleted the requirement that only trusts created for bona fide fiduciary purposes could be commingled in common trust funds, and thereby removed the test which the Federal Reserve Board had established as a bulwark to keep the banks out of the mutual fund business.

Mr. DINGELL. Thank you very much, Mr. Chairman.

I have some other questions but I will defer to my colleagues.

Mr. STAGGERS. Mr. Glenn.

Mr. GLENN. Mr. Cary, you certainly have shown that you have a very fine mastery of the subject.

I have been listening to you this morning and this afternoon, and you have apparently done a tremendous lot of staff work in connection with these reports.

I would like to get something clarified for the benefit of myself.

In the event a stockbroker-dealer wants to deal with the New York Stock Exchange, he has to belong to that exchange, is that correct, and with the American Stock Exchange, he has to belong to that exchange?

Mr. CARY. Right.

Mr. GLENN. But in the over-the-counter market, he does not have to belong to the National Association of Securities Dealers at this time?

Mr. CARY. It is true that there are a certain number of broker-dealers at this time, operating even on an interstate basis, who are not members of the National Association of Securities Dealers, that is correct.

Mr. GLENN. But they are supervised by you and regulated as broker-dealers?

Mr. CARY. That is correct.

Mr. GLENN. And it is proposed by this legislation that it should be compulsory for those broker-dealers to become members of the National Association of Securities Dealers?

Mr. CARY. That is correct, sir. We would like to have the NASD Act as a vehicle to set higher standards with respect to those persons, and other persons, and then for ourselves to remain in the supervisory or oversight capacity which I think is our proper role.

Mr. GLENN. Then would the NASD, in effect, be the same as the New York Stock Exchange organization and the American Stock Exchange organization?

Mr. CARY. Well, sir, in some senses it would be a counterpart with respect to the over-the-counter market. It would not be by any means the same.

For example, I think you could say that one factor will be definitely different in that on the exchanges it is still simply an elective, via an application, process. It is a membership in an organization which, to some extent, is elective and selective.

On the other hand, if our bill goes through, this will be an organization in which everyone becomes a part. It therefore has much more of the truly public quality than the exchanges themselves, although at this time, since they are conducting public markets, they are in quasi-public institutions as well.

Mr. GLENN. In your second statement which you made this afternoon, on pages 27 and 28 you outline very many things which the SEC will do in supervising the membership of the NASD. Is there any possibility of duplication of what you are going to do and what the NASD will do, or are you in more of a supervisory situation rather than doing the same thing which they would be doing?

Mr. CARY. By and large, Congressman Glenn, I think our role is basically a supervisory or oversight. It is true, however, that in major, for instance, disciplinary proceedings, and so forth, we may find it advisable and necessary to actually take an action against a particular broker-dealer on the ground that we think these are violations of our fraud statutes, for example. In that kind of a case, we will act ourselves as well as exercising our general oversight capacity.

I might just check, if I may, to see if Mr. Loomis might have any additions or supplements to what I have said thus far.

I want to make sure that I have not misstated myself at any point.

Mr. LOOMIS. I would have very little to add.

The main purpose of the suggestion of compulsory membership in some association, not necessarily the NASD because others can legally be formed if that be the desire of the dealers concerned, is to make sure that all broker-dealers are subject not only to the Commission's direct regulation to the extent that that applies, but also to some form of self-regulation, just as all exchange members are subject to the Commission's regulation, and also to the self-regulation by the exchanges.

Most broker-dealers are now economically required to join the association because membership is essential to engaging in various types of business.

This recommendation in the bill would pick up some few who have concluded that they could get along without joining.

Mr. GLENN. But the broker-dealers are still registered with the Securities and Exchange Commission and can be punished if they do something wrong, even though they do not belong to this NASD at the present time; is that right?

Mr. LOOMIS. Yes. If they violate the Federal securities laws, the Commission can punish them whether or not they are members of an exchange or the association or anything.

Mr. GLENN. Mr. Cary, has the SEC consulted with the various State governments on your proposal to extend the control over intrastate broker-dealers as well as those in interstate commerce?

Mr. CARY. I suppose when you say the State governments, I would assume you might refer, Congressman, to the so-called blue sky commissioners of the various States.

Every State, of course, has its agencies. It is the securities administrator. Sometimes we call him the "blue sky administrator."

I would say we did not have a formal conference with that group before we proposed this. We have had discussions with a number of them. We do meet with them at least twice a year and have their views.

As you may be aware, there is a group of securities administrators in the Midwest, the so-called Midwest Group, a number of whom have taken the position that is critical of certain aspects of, you might say, the second part of this bill; namely, the so-called compulsory aspect of incorporation of broker-dealers into the NASD.

You may have that in mind as a point which may have been underlying your question.

Mr. GLENN. I was thinking of my own State of New Jersey, as to whether or not you had been in touch with the commissioner of banking and insurance or anyone in his agency as to what their opinion would be as to the proposals which you make in this legislation.

Mr. CARY. You have, I believe, a securities commissioner, perhaps under the attorney general.

Mr. LOOMIS. It is my understanding, and maybe it has been changed, that in New Jersey the attorney general's office acts to supervise broker-dealers. We haven't had specific conversations with Mr. Conroy about this question, to my knowledge.

Mr. CARY. That is correct.

Mr. GLENN. Can you tell me more details as to what your meaning of the word "automation" referred to as to the different exchanges?

Is this something mechanically that is going on in the exchanges or is it something which is new to the building of various branches of the industry?

Mr. CARY. In effect, some of us have commented, Congressman Glenn, that, in a sense, this Special Study was fortuitously timed in that respect, because automation, as such, is having a profound effect in the industry. Already the major firms in the industry are either partially or heavily automated, in the sense that a great deal of their transactions are recorded by automated devices and they are using these large pieces of equipment furnished by such companies as IBM and others.

The things which we emphasize with respect to automation are these:

On the exchange side, we think automation offers us a wonderful opportunity to perform this kind of supervision or oversight that we referred to. Because, with the use of cards—and I am not an expert on automation, so I may state it in a rather primitive way—by taking the cars and analyzing a whole series of transactions on a particular day with respect to a stock we can get the picture of who has been involved in it, what type of situation it was, and who are the buyers and sellers.

In other words, if there were any manipulation, for example, we would be in a good position to ascertain it.

Now, automation to that extent will be exceedingly valuable to us from a regulatory standpoint.

When I move over from the exchanges to the over-the-counter market, I think it is of even more profound importance.

As you know, in exchanges what you have is a record of day-to-day, actual transactions, the purchases and sales. At the present time, the reporting in the over-the-counter market is not actual transactions but what the bids and offers are. I think through the automation process we are going to have a much better picture of the market because all the offers and the sales, offers and bids, and all of the pricing of the various firms from all over the country can be recorded, for instance, in one place, whether it be Chicago or New York.

We begin to have a basis for knowledge of that market which we have not had hitherto.

As I say, I stated it in a fairly elemental way, some of the impact of automation, but I think Mr. Ralph Saul, as Director of our Trading and Markets Division, might supplement my remarks, if I could ask him to do so.

Mr. SAUL. Mr. Chairman, I have very little to add. I would just say this. With respect to the exchange markets, I think one of the important impacts of automation is to reduce the tremendous burdens on members in reporting transactions for surveillance purposes. There are a great number of reports that members must file with the exchange in order for the exchange to find out if they are complying with both exchange and Commission rules. One of the potentials of automation is to reduce the amount of paper work and to increase the surveillance over exchange transactions. On the over-the-counter markets, I would say, just to elaborate a little bit more on what the chairman says, one of the great potentials here of automation is the possibility of getting some kind of central reporting of actual trans-

actions and actual prices in the over-the-counter markets. One of the things that we noted in the Special Study, and one of the great differences between the exchange markets and the over-the-counter markets was this absence in the over-the-counter market of central reporting of actual transactions and prices.

There is no question that if you got a reporting of actual transactions and prices that many of the problems that you are concerned with in the over-the-counter market would go a long way toward resolution.

Mr. GLENN. Thank you very much.

Thank you, Mr. Chairman.

Mr. STAGGERS. If a quotation is given in Washington at the end of the evening, when you pick up the evening Standard to see how many shares were sold, does that mean how many shares were sold across the Nation in the over-the-counter market, or is it just then those that were locally sold?

Mr. CARY. I may have to check this with Mr. Saul, but as I recall the quotations in the over-the-counter market do not provide the number of shares traded in or sold on that day. It is just on the exchanges, Mr. Chairman. What you find generally in the newspapers is the so-called bid and asked. It is not actual transactions or sales. That is only in respect of the exchanges themselves where they give the volume.

Mr. STAGGERS. I realize that. It does not give the volume of transactions, that is true. There is no way, then, of correlating that at the present time?

Mr. CARY. At the present time it takes an immense amount of analysis for us to get some impression of them. I think one of the very great benefits of the Special Study which you authorized was that for the first time really we had a picture of the over-the-counter market which we never had before. It seems to me that automation will, for instance, give us that kind of information which we have not had.

Mr. STAGGERS. Mr. Van Deerlin.

Mr. VAN DEERLIN. Mr. Cary, I noticed in your original statement this morning that over-the-counter sales have jumped from about $5 billion in 1945 to nearly $40 billion in 1961. Was there no over-the-counter problem back in 1934, to speak of?

Mr. CARY. I cannot say there was no problem. I would say its magnitude and its relationship was far less important. I think perhaps I might be able to give you some statistics on that to supplement it a little more.

I have here share value on exchanges and, the over-the-counter market. In 1950, there was $93 billion netted on the New York Exchange $13 billion on the American Stock Exchange and $45 billion in the over-the-counter market. Today, on the New York Stock it has moved to $387 billion; and on the American it has moved from $13 to $33 billion between 1950 and 1961. And on the over-the-counter market it has moved from $45 to $105 billion.

Mr. VAN DEERLIN. There is a considerably greater share in the total transactions of shares.

Mr. CARY. That is correct. I want to mention that there has just been called to my attention certain remarks at page 7 of my statement.

I said because too little was known about the over-the-counter market in 1934 to enable Congress feasibly to devise provisions as specific as those related to listed securities, the original section 15 of the exchange granted the Commission rulemaking power in relation to the over-the-counter market. In doing so, the expressed purpose of Congress was to insure investors in over-the-counter markets protection comparable to that provided investors in listed securities.

The sanctions made available, however, proved inadequate because of their focus upon brokers and dealers rather than companies. As you know, our bill now goes to companies. The provision was repealed. It seems to indicate that we really had very little knowledge about the over-the-counter market at that time, and as a consequence what little controls were offered under the statute at that time were controls over brokers and dealers rather than over the companies themselves. That is what we are turning to this time in providing that a large number of companies on the over-the-counter market should be subject to our reporting requirements, the proxy provisions and to the insider training provisions.

Mr. VAN DEERLIN. And as to membership in the NASD?

Mr. CARY. As to companies in the over-the-counter market, they would not be members of the NASD, but we would provide in the second part of the bill that the broker-dealers themselves dealing in the over-the-counter securities and who presently are not members should become members of the NASD.

Mr. VAN DEERLIN. I believe in view of the hour, Mr. Chairman, that we might wish to recess soon.

Mr. STAGGERS. I will state now that we will recess at 5 o'clock. Mr. Cary has done very well.

Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman.

The Chief counsel for the study group made a speech which was referred to a few days ago in the paper. I sent for a copy of it. He, Mr. Richard H. Paul, was quite critical, or at least the press picked up the critical aspects, of his talk. This happens to administrative agencies as well as to the congressional branch of the Government. I have his speech before me. He said, "The study turned up instance after instance of highly questionable conduct in the securities markets, carried on not alone by the marginal element of boiler-room operators and the like, but within branch offices of our largest, most respected, and most influential firms. I might give just one 'for instance'."

He goes on to say that in selling involving shares of what can most charitably be described as a highly speculative company in a brief period in 1961, some 80 different retail brokerage firms sold 600,000 shares of the stock to more than 2,000 public investors, many of whom suffered substantial losses. Among the brokerage firms involved were more than 10 New York Stock Exchange members—member firms who would be numbered among the blue-chip firms of the exchange.

Do you know to what instances he is referring?

Mr. CARY. Yes, sir. It is in the report. He is referring, I believe, to the Aquafilter stock; that situation is spelled out in great detail in the report. I cannot myself give the page, but I suspect one of the men here can provide it for the record before the end of this day. I think you will find it fairly clear.

Mr. KEITH. I know it is in the report. I just wanted to be certain that you knew the instance.

Mr. CARY. Yes, sir.

Mr. KEITH. What do your recommendations do to correct that kind of a situation?

Mr. CARY. Well, sir, the steps we are taking certainly should provide some solutions to those problems. First of all, I would think the steps we are making in connection with selling practices would be helpful. Another vital point is better supervisory controls over branches in these large firms.

One of the things that we are doing in following up on the study is to try to force the level of supervision of these large firms to a higher point than it has been in the past. I think that will definitely be a factor. The facts of the matter are in that case, if I am not mistaken, that the particular brokerage firm there involved reimbursed all persons who had been damaged in connection with it. It was the result of activities by two or three branch offices all located in a very narrow area in California.

Mr. KEITH. As I read it here, it is much broader in scope than that, because they talk about 10 new New York Stock Exchange member firms who were involved, some 80 different retail brokerage firms selling 600,000 shares of stock.

The point I am trying to get to is that here are some highly regarded member firms of the stock exchange where presumably the personnel has not much changed in those organizations today from what it was at the time this took place. Under the philosophy that you are recommending for the policing of the securities business as a whole, it is to enlarge the membership and the scope of activity of organizations like the New York Exchange, further removing yourself from this particular area of policing. It would seem to me, pursuing the line of Mr. Glenn, that there is something to be said for the point of view of these independent operators who want to have the policing by the SEC, particularly with reference to mutual funds. It might be that the public interest would be better protected by more direct supervision by the SEC than by further extending the self-regulating power and responsibility.

Mr. CARY. Congressman Keith, if I could start to answer that and then ask two people from the Commission to answer, I would appreciate it. First of all, let me say that there were some remedies in that particular case. I believe the partner of that firm who was involved is no longer active in that firm.

Second, disciplinary actions are either underway or have been undertaken, and we are participating in that as well as one of the regulatory agencies. I will have to leave that to Mr. Saul to give us further details.

I think you can be sure, further, that although we are vesting some further responsibilities, as you indicate, in the exchanges and in the NASD, we also feel that as we do so, our oversight has to be deeper than it has been in the past.

Finally, I want to assure you that we will not cede jurisdiction with respect to major fraud cases, for example, and disciplinary actions of that type, to those agencies exclusively.

We feel that when a violation of the Federal laws is involved, we ought to step in. Indeed, we do in cases of that kind.

I think those are some of the points that may be in response to your question, but I think I may not have fully covered it. I would like to ask Mr. Saul or Mr. Loomis to speak further to it.

Mr. SAUL. Congressman Keith, I just have one further point to add to what the Chairman said, and that is on the Aquafilter situation, it was described in the report primarily as an example of a breakdown, a partial breakdown, in controls over branch offices. One of the things that has concerned the Commission, and which was a subject of study of the Special Study Group, was this supervision of branch office personnel.

What you witnessed in the *Aquafilter* case was this problem of supervision of branch offices. It was primarily that the Aquafilter situation was placed in the report as an example of that problem of supervision.

We recommended in the special study, and this was recommendation No. 1 of part B of chapter III, dealing with selling practices, that the supervision by broker-dealers of the selling activities of their personnel, particularly in branch offices, should be generally strengthened by the adoption of appropriate procedures, and so on.

Mr. KEITH. I think that is self-evident. One of the first principles of any command or procedure would be to do just exactly what you recommended. Of course, what we learn is by example. What did you people do in the way of exercising your responsibility? How many people did you prefer charges against in connection with this?

Mr. SAUL. There has been a significant action taken, Congressman Keith, since the Special Study Report. The New York Stock Exchange has put into effect new procedures for the inspection and supervision of personnel.

Mr. KEITH. I think Mr. Cary led me to believe that you took action yourself. What did you do?

Mr. SAUL. In the *Aquafilter* case, no action has been taken. As I mentioned, I think it was primarily a problem of supervision, so far, at least; on the facts that we had available, it did not appear to be the basis for disciplinary action to be recommended to the Commission.

Mr. KEITH. In other words, there was no real misrepresentation of the situation to the buying public that needed the attention of the SEC?

Mr. SAUL. No, I think, Congressman Keith, it goes beyond that. I think it is primarily a problem of supervision. As we saw it, it didn't seem to involve a question of Commission disciplinary action. It seemed to me that the problem involved a much larger problem and that is the problem of supervision of branch offices. I think that the New York Stock Exchange has been taking significant steps in that direction.

It would seem to me that that is the area, the more significant area, where action should be taken.

Mr. KEITH. I would say that they would be encouraged to take this action if they found some direction on the part of the SEC if there were as many as 600,000 shares of stock sold to more than 2,000 investors who suffered substantial losses.

Mr. CARY. May I ask Mr. Loomis to supplement this with his knowledge with respect to this particular case?

Mr. LOOMIS. I would like to add a few things to what Mr. Saul said.

This was an example of the type of thing that went on during this "hot issue" period, and in addition to the supervision problem that Mr. Saul described, there was the problem of salesmen giving advice upon the basis of insufficient information, and lots of rumors being circulated around and planted by various people which were uncritically picked up by securities salesmen and repeated.

That isn't the type of thing necessarily that you discipline a person for until you have raised the standards. There is one other important aspect, also: This was an over-the-counter company, and although it had a large number of stockholders, as pointed out, it was not reporting and there wasn't reliable information available about it, with the result that the vacuum was filled with all types of miscellaneous misinformation, the sources of which none of us were able to check.

So in addition to the things which Mr. Saul has suggested, certainly the study recommendations with regard to the quality of investment advice, the requirement that people check the sources of their information, and the material proposed by this bill, to require over-the-counter companies to report so that there would be some reliable information available, would contribute to the solution of this problem.

The broker-dealer firm that was principally involved in selling this stock to the public, when it learned of the fact that its salesmen had gone off the deep end, so to speak, reimbursed the investors for their losses. This was another reason why we didn't think it necessary to act agains that firm. Under present law, we couldn't act against the salesmen individually.

The bill you have before you would remedy that defect so that if the case occurred again, we could proceed against the individual salesman without having to proceed against the whole firm when it had done all it could to make good and try and clean up the situation.

Mr. CARY. I might want to ask Mr. Loomis to clarify one thing I have said, Congressman Keith. I indicated that I thought action was taken with respect to the partner in charge of the branch office there by one agency or another, and I may be incorrect. I would like to ask him to clarify that point for the record.

Mr. LOOMIS. I believe that is incorrect. I think that the chairman may have had in his mind the other cause celebre which is described in the study where that did happen.

Mr. KEITH. My point, Mr. Chairman, is simply to try and develop the sensitivity on the part of the Congress of the need to keep the SEC's responsibility very clear in such an instance as this sort, and to show that we are not going to solve things just by going along with the Senate version which makes mandatory membership in the National Association of Securities Dealers or some association of mutual fund dealers.

There may be certain value to having the SEC maintain a closer responsibility for supervision than would be the end result if we further strengthened the NASD or created a mutual fund organization for that purpose.

I notice it is 5 o'clock, Mr. Chairman. I appreciate very much your letting me ask these questions.

Mr. CARY. I just want to repeat my assurance that we will not be ceding jurisdiction. This is using the NASD as a medium to raise standards, as a vehicle to raise standards, which we think would supplement activities in which we are already engaged.

Mr. STAGGERS. Mr. Chairman, all of us want to thank you for your presentation today. You are certainly patient and have great help in explaining the matters before us. To me, the job is increasingly difficult. We have many things to go into in this hearing. If you will agree to return again at 10 o'clock tomorrow, we will resume.

(Whereupon, at 5 p.m. the subcommittee recessed, to reconvene at 10 a.m., Wednesday, November 20, 1963).

INVESTOR PROTECTION

WEDNESDAY, NOVEMBER 20, 1963

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND
FINANCE OF THE COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The subcommittee will come to order, please.

As we recessed last night, Mr. Cary was answering questions of the committee. At this time we will commence with Mr. Curtin. Mr. Curtin?

STATEMENT OF WILLIAM L. CARY, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY BYRON D. WOODSIDE, COMMISSIONER; MANUEL F. COHEN, COMMISSIONER; JACK M. WHITNEY II, COMMISSIONER; PHILIP S. LOOMIS, JR., GENERAL COUNSEL; EDMUND H. WORTHY, DIRECTOR, DIVISION OF CORPORATION FINANCE; ALLAN F. CONWILL, DIRECTOR, DIVISION OF CORPORATE REGULATION; RALPH S. SAUL, DIRECTOR, DIVISION OF TRADING AND MARKETS; WALTER WERNER, DIRECTOR, OFFICE OF PROGRAM PLANNING; ANDREW BARR, CHIEF ACCOUNTANT; ARTHUR FLEISCHER, JR., EXECUTIVE ASSISTANT TO THE CHAIRMAN; AND MORGAN SHIPMAN, SPECIAL COUNSEL, OFFICE OF PROGRAM PLANNING, SECURITIES AND EXCHANGE COMMISSION—Resumed

Mr. CURTIN. Thank you, Mr. Chairman.

Chairman Cary, I want to first congratulate you on a very fine presentation yesterday. You had an extremely lucid statement which you presented very well.

Mr. CARY. Thank you, sir.

Mr. CURTIN. There are, however, one or two features of this proposed legislation on which I have some questions, one of which is this compulsory membership in NASD.

As I understand section 6(a), it provides compulsory membership by broker-dealers in NASD or any similar private, self-regulatory industry group, which might be registered with the SEC; is that correct?

Mr. CARY. That is correct, sir.

Mr. CURTIN. This is the first time that the Government has sought to provide for compulsory membership in any such type of an organization; is that not correct?

Mr. CARY. The first time in the securities industry. I can't speak to other areas of activity, Mr. Curtin. But you are right, it isn't actually compulsory in the securities industry and has not been up to this time.

Mr. CURTIN. Even membership in the New York Exchange and in the American Exchange is purely voluntary; isn't it?

Mr. CARY. That is purely voluntary; yes, sir.

Mr. CURTIN. Why is it that you now feel that you must have compulsory membership in this voluntary association or any similar one?

Mr. CARY. I would like to speak to it first and then I may ask our general counsel, Mr. Loomis, to supplement my discussion.

First of all, Mr. Curtin, we have to think of the fact that our primary objective here is raising standards, including the setting of certain qualifications, both with respect to experience and competence, and also minimum capital. The question is how do we do it, how do we raise those standards?

It seems to us that either it has to be done by the Government, on the one hand, or it has to be done by an organization which is quasi-public in character, such as the NASD. We feel that this is an area in which we, ourselves, should not so actively get into. This question of having exams, for instance, Mr. Curtin, would be a problem. It is a cost, first of all, and it is also the kind of activity which we feel we shouldn't expand into as the Federal Government.

It would be better for standards of qualification to be established by a quasi-public organization, such as the NASD. Moreover, those persons who are presently outside the NASD have to become members of it in order that they will be subjected to those standards, which, of course, we would generally supervise. Our role then would be sort of supervisory or oversight.

Mr. CURTIN. I can understand the organization, itself, setting up requirements for membership, but you expect to say to the organization, "You will charge such-and-such an annual fee for membership in your organization," and you will set up other standards of membership; is that correct?

Mr. CARY. That is a separate question. I do think that I should speak to it. Undoubtedly, as you indicate, some of the functions that the NASD will perform with respect to these people, as with respect to its own members, will involve some cost. Therefore, they have to set a fee for it. We do have a general oversight capacity with respect to the fees charged the NASD as well, so that we can insure that the costs imposed upon those persons or those firms that are compulsorily becoming members of the NASD will be not prohibitive; in other words, that they will be reasonable.

Mr. CURTIN. Mr. Chairman, if that reasoning is going to be carried to its logical conclusion, it seems to me that we could say that all lawyers that want to practice before any Federal court must be members of the American Bar Association; is that your argument?

Mr. CARY. I hate to get myself into analogies I haven't thought through at all. We do have, in various States, as you may know, a so-called integrated bar.

Mr. CURTIN. I belong to the bar of such a State so I am familiar with it.

Mr. CARY. I cannot speak to an expert in explaining it very much more. I suppose to some extent there is in that case a delegation of powers with respect to standards in the bar to the bar association, if I am not mistaken. However, since you are a member of a State bar in which they have an "integrated Bar," I wouldn't want to attempt to explain it further because I haven't thought it through.

Mr. CURTIN. Let me say, Mr. Chairman, that I happen to be a member of the Pennsylvania Bar Association as well as the American Bar Association, but membership in the Pennsylvania Bar Association is not compulsory to Pennsylvania attorneys who practice before the Supreme Court of Pennsylvania.

I know some very fine, outstanding, and distinguished lawyers that are not members of the Pennsylvania Bar Asssociation.

Mr. CARY. I appreciate that. Some States—I think Michigan, for example—do have a so-called "integrated bar" where every member of the bar has to be a member of the bar association. There they use the bar association as a vehicle for, you might say, Government and control.

The thing that we are worried about is having the Federal Government get too deeply involved in this question of qualifications of persons.

That is why we would like to have it handled by some other organization, which is quasi-public.

Mr. CURTIN. Carrying your opinion a step further, would you say that the ICC could provide that officials of all railroads would have to be members of the American Association of Railroads?

Mr. CARY. Of course, the difference between the ICC, for example, and ourselves, is that we are attempting to raise standards; that is, establish higher standards of competence, training, and character, for those persons who are dealing with the public as quasi-fiduciaries. I don't think the ICC, for example, has the same kind of responsibility. Moreover, the NASD is a creature of the Congress and was expressly authorized as a vehicle of self-regulation for the over-do-counter market.

May I ask Mr. Loomis if he might be able to supplement anything I have said so far?

Mr. LOOMIS. Thank you, Mr. Chairman.

I think the chairman has explained basically the reason for this. First, to indicate what the NASD is, it is not a trade association in the ordinary sense. It was set up under an act of Congress almost as an instrumentality of the Government for the purpose of providing a self-regulatory body in the over-the-counter market.

In the exchange market, the exchanges have acted as self-regulatory bodies and the statute requires them to. In order to do business on the New York Stock Exchange, you are required to be a member or associated with a member firm. In effect, membership is almost compulsory to get into that business, because you can't do business on the exchange unless you are a member.

There was no such situation in the over-the-counter market. But Congress did feel, in 1938, that there should be an official, self-regulatory body in the over-the-counter market and provided for setting up

these associations whose function is not the ordinary trade association function, but the function of self-regulation. This is what they are there for.

Now as the chairman pointed out, they have gotten into this area of fixing qualifications to engage in the business, and they will get deeper into it under this legislation. In order to do this, they have fairly elaborate programs of exams for prospective members and prospective salesmen, and for registering these people, setting up courses of study that they have to follow.

Mr. CURTIN. I would like to interrupt at that point. Under your proposed legislation, the SEC would set up the yardstick for those regulations, would they not, and tell the NASD just what those regulations would be?

Mr. LOOMIS. Well, they would have to be approved by the Commission; that is, they have to be filed with the Commission and the Commission has to find that they are not inconsistent with the purposes of the act. The NASD would have the initiative to establish them, and the Commission has the power of oversight to examine them and determine whether or not they are proper. In fact, it is necessary to have standards of qualification, and education, and training, in this technical kind of business.

Mr. CURTIN. Then it is your position that this is necessary for the public interest?

Mr. LOOMIS. I think it is necessary in the public interest that standards of qualification, experience, and training be established more or less uniformly in the securities business, and that, therefore, the choice we have is the one that the chairman mentioned; that is, either the official self-regulatory instrumentality should do it, or the Commission should do it. The Commission is a little reluctant to.

There is an additional problem: It costs money to establish these courses of study, to prepare these examinations, to give them to maybe 100,000 people that are involved, to grade them, to keep all the records. It is a fairly expensive process.

Mr. CURTIN. How many broker-dealers registered with the SEC are presently members of NASD?

Mr. LOOMIS. We have those figures. They were referred to in the Chairman's statement yesterday at page 56. There are approximately 1,000 registered broker-dealers who are not members, but when you get down, you will find that 40 percent of them are firms that are not in business——

Mr. CURTIN. Is that 1,000 firms or 1,000 members?

Mr. LOOMIS. 1,000 firms.

Mr. CURTIN. How many members?

Mr. LOOMIS. There are about 4,700, roughly, members.

Mr. CURTIN. Presently in the NASD?

Mr. LOOMIS. In the association. But of the 1,000 brokerage firms who are not members, it appears that only about 300 or so would be affected substantially by this compulsory membership, if you look at the breakdown on page 566 of the Chairman's statement.

Mr. CURTIN. How many of these broker-dealers registered with the SEC will have to become members of NASD if section 6(a) becomes a part of the law?

Mr. LOOMIS. We estimate, and these are based on the Special Study figures and the numbers may have changed since last year, that there would be something in the neighborhood of 300 of the registered broker-dealers who would have to become members.

Mr. CURTIN. 300 more in addition to the 4,700?

Mr. LOOMIS. That is right.

Mr. CURTIN. Section 6(a) provides for certain exceptions to the compulsory membership, does it not?

Mr. LOOMIS. That is right.

Mr. CURTIN. How many of the broker-dealers registered with SEC would not have to become members of NASD under these exemptions?

Mr. LOOMIS. These figures in the chairman's statement referred to about 700 firms and indicated that most of these either are not in business—they have registered with us but haven't gone into business—and that accounts for about 40 percent of them.

Mr. CURTIN. About 700 firms, but how many members?

Mr. LOOMIS. These are not members at all. I am talking about nonmembers.

Mr. CURTIN. But I would like to know how many persons would not become compulsory members of NASD? How many registered broker-dealers would not become compulsory members of NASD if this bill becomes law?

Mr. LOOMIS. We don't know exactly. But let's say based on the figures that are here, about 250.

Mr. CURTIN. So if this law becomes effective, according to your statement, NASD will pick up about 300 members, but 250 firms will not be affected?

Mr. LOOMIS. That is right. Those are firms that are either exchange members, who do almost all their business on the exchanges but are registered with us as a matter of precaution, so to speak, or else they are firms who are not really in the securities business but sell savings and loan, insurance, real estate, and the like, but, again, are registered with us as a matter of precaution.

We thought that these two types of firms might appropriately be exempted.

Mr. CURTIN. If the purpose of this compulsory membership is the public interest, wouldn't the public interest be better served if all broker-dealers became members rather than have exceptions?

Mr. LOOMIS. I think that as to firms which are members of stock exchanges, for example, the public interest doesn't necessarily require that they become members of the NASD because they are subject to self-regulation through the medium of the exchanges, who require all these qualifications. As to people who are not really in the securities business at all, the public interest may not require that they become members of the NASD.

Mr. CURTIN. I have had some small brokers get in touch with me who are somewhat concerned about the dues feature of this problem. Is my information correct that under your proposed compulsory membership regulations, there would be a membership fee of $150 for each brokerage house?

Mr. LOOMIS. I believe that is right; yes.

Mr. CURTIN. And there would be a registration fee of $7 per man in addition?

Mr. LOOMIS. I believe that is correct.

Mr. CURTIN. With a maximum fee of $10,000?

Mr. LOOMIS. Well, it is unlikely that most firms would get up to the $10,000 because of the way they figure it, which is on the basis of the number of branch offices and the amount of underwritings they participate in, and firms which are big enough to have lots of branch offices and to participate in underwritings are generally members anyhow.

Mr. CURTIN. But there is a $10,000 ceiling?

Mr. LOOMIS. There is a $10,000 ceiling but that is usually paid only by the larger firms, most of which are already members.

Mr. CURTIN. A small brokerage house that we will say has three members would pay $150, plus the $21, which would thus average out about $57 per member as the cost of belong to NASD for that year. On the other hand, a very large firm having, we will say, 3,000 employees, should pay $150, plus $21,000, at $7 per man. However, with a limitation of $10,000, such large firm will end up paying about $3 per person; is that correct?

Mr. LOOMIS. I am not sure how you get the $3 figure.

Mr. CURTIN. I understand, for example, that the Hamilton Fund has approximately 3,000 employees, and paying the $150 for the registration of the house, plus the $7 per man, it would run into a very substantial figure, a figure substantially over $10,000. But $10,000 is the maximum they are going to have to pay. So if you divide the $10,000 among the employees, you will come up to about $3.30 per man. It would seem to me that this would be a form of graduated income tax in reverse.

Mr. LOOMIS. Except for the fact that a firm like the Hamilton would also, in addition to the $10,000 membership, would have to pay a fee for having their employees examined. I have forgotten the exact amount, but it would operate to raise their cost.

Mr. CURTIN. To raise it to the $57 per man of the three-man outfit?

Mr. LOOMIS. There is a fee of approximately, I think it is, $50 a man for—well, it is $20 for the application and $30 for taking the examination. As a firm like Hamilton that would pay that, you would find that that would increase the expense that they would have.

Mr. CURTIN. Aside from the examination fee, which all must pay, still a very large firm will average out substantially less cost for membership than a small one, will it not?

Mr. LOOMIS. Not necessarily, at least on the first examination. For continuing membership after their people have all been examined, you are probably right that they would pay less per man in continuing fees.

Mr. CURTIN. I also note that the proposed section 6(b) would amend existing law to have the law read that persons under your jurisdiction would be persons "associated" with broker-dealers, amending out the words "persons controlled by broker-dealers"; is that correct?

Mr. LOOMIS. Yes; but let me explain.

Mr. CURTIN. Does the relevant section in existing law read substantially as I have mentioned?

Mr. LOOMIS. It refers to persons generally in terms of partners, officers, directors, branch managers, or any person directly or indirectly controlling or controlled by such broker-dealer.

Mr. CURTIN. So that under the present law, the persons under the jurisdiction of the SEC are persons who are controlled by the broker-dealer?

Mr. LOOMIS. Controlled or controlling; either way.

Mr. CURTIN. Under the law as you would have it amended, that jurisdiction would be enlarged?

Mr. LOOMIS. No, sir.

Mr. CURTIN. Don't you want jurisdiction enlarged to "persons associated with broker-dealers"?

Mr. LOOMIS. Yes, we do; but if you would look at the first part of the bill, section 2 of the bill, which contains the definitions, there is a definition of term "person associated with a broker-dealer" and that definition is almost identical with present law. It refers to partner, officer, director, person controlling or controlled by, so that all that has been done is to have a shorthand phrase, "person associated with a broker-dealer," instead of repeating the full language of the present law at various places. There is no change of substance here.

Mr. CURTIN. If, as you say, there is no change in jurisdiction intended, why do you seek this amendment?

Mr. LOOMIS. It doesn't change the law.

Mr. CURTIN. Why do you wish to amend that section, then?

Mr. LOOMIS. That is what I wanted to explain.

One of the things that is done by this amendment is to authorize the Commission to take action directly against individuals instead of taking action against firms, as you will recall. Now, as a matter of draftsmanship, in order to do that, we had to, in various places, authorize disciplinary action against individuals, and it seemed simpler to use a simple phrase, "person associated with a broker-dealer," instead of repeating over and over again in the statute the words partner, officer, director, branch manager, and so on.

Mr. CURTIN. Why can't you just repeat the words the "person controlled by" as it now is, rather than "person associated with"?

Mr. LOOMIS. Because we wanted to preserve the concept now in present law of reaching not only persons controlled by, but also partners, officers, directors, branch managers, and persons controlling, to make it clear that we were not changing the law and excluding those people from the category.

Mr. CURTIN. It seems to me that the term "controlled by" is phraseology that is very vague and indefinite. Pretty nearly anybody could be classed as "associated with" a broker.

Mr. LOOMIS. But the term is defined, however, in the statute, using the same language as in present law, so that it doesn't mean anybody; it means the people enumerated in the present law. That is what is provided in the amendments to section 3(a) of the Exchange Act, new section 3(a)(18) on page 2 of H.R. 6789 at the top of the page.

Mr. CURTIN. I would like a little further clarification by you, Mr. Cary, if you would, on the elimination of the "intrastate exemption." In Pennsylvania we have a very good Pennsylvania Securities Commission who, I understand, does a fine job in protecting the investing public in Pennsylvania. With the elimination of this intrastate exempton, you will practically put them out of business; is that correct?

Mr. CARY. No, sir; we do not think that we will. I may refer to the discussion at page 63 of my statement. We do not believe that,

by eliminating the intrastate exemption, it will necessarily put them out of business. It will create a new supervision with respect to intrastate workers.

Mr. CURTIN. What jurisdiction will they still have?

Mr. CARY. This will not in any way reduce the amount of activity in which the State securities authorities may engage. In other words, we are not foreclosing them from any of their present activities.

Mr. CURTIN. But by the eliminating of this provision, you are extending your jurisdiction into intrastate business, are you not?

Mr. CARY. We are actually relying on the fact of their use of intrastate facilities and the mails. As a matter of fact, therefore, from a constitutional standpoint or otherwise, we are relying on interstate activities as a basis for bringing them within the law.

Mr. CURTIN. But you are extending your jurisdiction into intrastate business.

Mr. CARY. Maybe I better ask Mr. Loomis to explain it.

Mr. LOOMIS. We are not extending our jurisdiction very far. That is true because of the fact that under——

Mr. CURTIN. What do you mean "extending it very far"? My question is whether or not you are not extending your jurisdiction into purely intrastate business. You say "not very far." That is a relative term.

Mr. LOOMIS. All I was starting to say was that we already have a certain amount of jurisdiction over purely intrastate business. That is, for example, the fraud provisions of the present law apply to these purely intrastate firms if they use the mails in their business, and various other provisions of the statute, such as the capital rules, similarly apply to them if they use the mails, which they do.

So the only change that is made here substantively is to also require them to register with us and to comply primarily with our bookkeeping rules so that we can——

Mr. CURTIN. To ask who to register with you?

Mr. LOOMIS. The intrastate broker-dealers.

So that we can perform the responsibilities that Congress has already given us to enforce the fraud and capital provisions as to these intrastate broker-dealers. If we had no jurisdiction over them at all, the problem would be different. Our main concern is that we have jurisdiction, but no adequate means of enforcement.

Mr. CURTIN. You said a moment ago that you were extending your jurisdiction just a little bit. You now say that you will require them to register with you and file reports with you. It seems to me that that is going somewhat beyond "just a little bit."

Mr. LOOMIS. That is a matter of degree, perhaps, but the main thing is that they are subject to the fraud provisions, and unless we know who they are and where they are located, and can look at their books, we can't very well enforce those provisions.

Mr. CARY. Mr. Curtin, may I add just one thing from yesterday's discussion?

You may recall that I did ask to be inserted into the record an article from the Wall Stret Journal dated, I think, in June of this year, dealing particularly with Indiana. The article pointed out that there were a number of cases in which intrastate dealers were conducting activities which were very disturbing to the Indiana Securities Commissioner—who, as I recall, had only one man to assist him.

In those areas we already have some jurisdiction when intrastate brokers use the facilities of interstate commerce, or the mails. We have responsibility, for example, through our general antifraud provisions. This is in answer to your earlier question. The bill is an extension, a limited extension, of our jurisdiction; but the facts of the matter are we have some responsibility with respect to intrastate brokers. We don't have quite all the tools, we don't have all the registration facilities at the moment which would carry out that responsibility, in our opinion, adequately. In a State like Indiana, they were really concerned and felt that we should be participating.

Mr. CURTIN. Have you, or any members of your Commission, discussed this extension of your jurisdiction and the elimination of the intrastate exemption with any of these State boards? Did you get their opinions before this bill was made up?

Mr. CARY. I would say that we have had discussions with individuals but we did not discuss it formally with the State securities commissioners, to my knowledge.

We have had meetings with them. Indeed, we had a meeting not too long ago. We were in New Orleans. I think there were at least eight of us who attended the annual meeting of the Association of Securities Commissioners, the so-called NASA.

Mr. CURTIN. Did you tell them what you proposed to do?

Mr. CARY. We told them and we had discussions. There have been, I would say, objections on the part of certain of the State administrators and there is no objection on the part of the others.

Mr. CURTIN. Then their enthusiasm was not unqualified?

Mr. CARY. It is unlimited in the case of some; it is less enthusiastic on the part of the others.

Mr. CURTIN. Thank you, Mr. Chairman.

That is all, Mr. Chairman, thank you.

Mr. STAGGERS. Mr. Van Deerlin?

Mr. VAN DEERLIN. Mr. Cary, when the NASD came into being, I think it was Mr. Loomis who said it was at the behest of the SEC. What is the history of that organization? Just state it in very brief terms.

Mr. CARY. I will start with that and perhaps Mr. Loomis or Mr. Whitney may fill in on it. Let me say in general we had a form of self-regulatory agency in the exchanges themselves, but there was no counterpart on the over-the-counter side. As a consequence, in 1938, there was the so-called Maloney amendment, which is now 15A of the Securities Exchange Act of 1934. This provided that associations could be formed, provided that they met certain standards. The only association that has been formed under 15A of the Securities Exchange Act is the National Association of Securities Dealers. The NASD basicaly originated in the belief of Congress that there was a necessity to have a self-regulatory agency or agencies on the over-the-counter side equivalent or at least a counterpart to that on the exchange side.

I might ask Mr. Whitney to speak to this further. He might want to supplement this point. Commissioner Whitney.

Mr. WHITNEY. Congressman Van Deerlin, prior to the adoption of the Maloney Act of 1938, back in the NRA days, there was a code authority, if you wish to call it that, representing the securities indus-

try. It was in the nature of a self-regulatory body. After the *Schecter* decision in the Supreme Court in 1935, which held those code organizations unconstitutional, it is true that the Commission, I think speaking through its then Chairman, asked the industry to continue some form of voluntary self-regulation without the benefit of the congressional sanction. This they did. They then found that they were unable to do the job which they were willing to undertake and which the Commission wished them to undertake because they did not have any enforcement powers, really, over their members. Thus, they were relegated to the status of a trade association. It was this that led to the initiative on the part of the Commission, supported by the industry, to secure the adoption of the Maloney Act of 1938. That act made the association, and the only one we have, the NASD, an arm of the Commission or of the Government, if you please, in raising the standards and exercising control over the industry by themselves. So we have a long history in the industry under Commission supervision and with Commission encouragement of just this sort of an association.

Mr. VAN DEERLIN. Can you give me examples of standards that are imposed by Government on the association?

Mr. WHITNEY. The statute lays out the general tests which an association must meet in order to register under the act. Those standards you will find in this same section, 15A. I might mention just a few of them. First, the association must be able to comply with the provisions of the Securities and Exchange Act of 1934, and our rules, the Commission's rules, thereunder.

The statute also provides standards for the basis of membership of firms in that association. For example, the rules may permit the association to restrict membership on a geographical basis, or the type of business, or other appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors. They are quite detailed, these provisions, throughout this part of the act governing the standards which the association seeking to register must meet. In effect, the first touchstone is the protection of the investors and the second is fairness of the association's organization, vis-a-vis its membership.

Mr. VAN DEERLIN. I assume there are certain additional standards not required by Government which the association may impose?

Mr. WHITNEY. That is an important point. One of the things that the association can do which the Commission cannot do is to impose upons its members ethical standards of conduct which go beyond the legal standard. The legal standard might be considered a minimum basis for entry into the business, but an association such as this, precisely in the same manner as you find in the case of the stock exchanges, can impose higher standards. Of course, they are legal but they are more than legal. They represent a higher standard. And we encourage them to do that.

Mr. VAN DEERLIN. Is there any field of standards in which the Government tells the association it may not impose requirements?

Mr. WHITNEY. We had one incident back in 1942 when the NASD proposed to establish a minimum capital requirement for its members. The Commission considered the matter and concluded that that was not a basis for membership that the NASD should incorporate in its rules. This Commission as it sits here today regrets that decision and we are attempting to reverse it in this legislation.

Mr. VAN DEERLIN. The fee has been referred to as a minimum of $150 per member firm. Does anybody have an idea what an average would be among the 300 firms to be affected by this legislation if it passes?

Mr. WHITNEY. No, sir; I am sorry. I don't think we do.

Mr. CARY. I am afraid we would not be able to provide that at this time. It would be impossible without analyzing each of the firms and then summing them up and taking the average. I don't think we have that available at the moment.

Mr. WHITNEY. We should point out, I think, sir, that the NASD is reviewing its fee schedule at the present time, in response to some of the comments made by the Special Study. If this legislation is enacted you would find that we would then have to review with them the form and structure of that fee schodule as they then would have to live with it, with this additional membership. I don't think they know or we know exactly who these people are, how big they are, and so on.

We would have a census probably so that the schedule would make sense for the population that we would then be dealing with.

I do have here an item that was just handed me referring back to 2 years ago. Under the 1961 fee schedule of the NASD, when the basic membership fee was $65, about 70 percent of the membership was assessed under $100. Between 1956 and 1960, the percentage of all members falling in this category ranged from 63 percent in 1959 to 78 percent in 1957. We have mentioned here, of course, that the minimum fee has been raised to $150 as of the present time. This, again, is in direct response to the efforts of the Commission and the willingness of the NASD to accept greater burdens and take on a bigger chore. Their current budget is $3 million, and those dollars are not easy to come by for this Commission.

Mr. VAN DEERLIN. No. I hastily computed that the $150 minimum fee multiplied by 300, and I offer this as one who isn't able to help his children in arithmetic beyond the fourth grade, would come to $45,000. Somewhere in Mr. Cary's testimony yesterday there was an estimate of what additional policing by the SEC would cost the taxpayers. I am wondering if this money is used essentially to do a job of policing, or whether it is used in other functions of a trade association.

Mr. CARY. I think I can respond to that. I believe at least one figure I had in my materials which referred to cost was an additional $600,000 which we believed would be necessary with respect to the disclosure aspects of the bill, namely, to require reporting by a large number of over-the-counter companies. That is quite separate from this problem. In further answer to your question, the NASD is different from the exchanges in one very marked respect—practically all of its funds are used for regulatory purposes and not for institutional advertisement or public relations. The NASD by and large has not been an organization which has advertised itself in any way. It has more of a regulatory function; all of its funds have been devoted to regulatory purposes, for instance, the creation of examinations which will be involved in the event that H.R. 6789 should go through.

Mr. VAN DEERLIN. Is there no question as to the legal authority of the NASD to police its membership in the field of public protection?

Mr. CARY. We do not think there is, in the light of the history which Mr. Whitney outlined in the first instance and, second, in the light of the existence of substantial review powers by us in respect to the rules and in review over disciplinary proceedings and actions which they take.

Therefore, the constitutional question and the question of power, in our opinion, is fully taken care of.

Mr. VAN DEERLIN. Has there been any evidence elicited to determine whether there is a greater incidence of fraud among nonassociation members, or among members of the association, in the principal fraud cases that SEC has prosecuted?

Mr. CARY. I will ask Mr. Whitney to speak to that.

Mr. WHITNEY. I can't recall the point in the Chairman's statement of yesterday that did bear on this, Congressman Van Deerlin, but it is true that, again without being able to quantify precisely as any of us might like that our regional administrators find, time and again, that some of their most expensive, in terms of man-hours, and troublesome cases arise in the intrastate area, for precisely the reason that Mr. Loomis mentioned a few minutes ago. A matter arises where we don't know who these people are, we don't know what their financial condition is, they are under no obligation to cooperate with us or provide information to us without a subpena. We have to do an investigative job that is far more expensive in terms of our efforts in those kinds of cases than in the cases where the firm is a member of the NASD and has registered with us. It is a practical problem.

However you wish to characterize the extension of our jurisdiction, it is not a question of our seeking to do that just to extend jurisdiction, we are trying to make more efficient and enforcement obligation which we already have.

Mr. VAN DEERLIN. I think the question of the committee members perhaps suggests a feeling here that, by extending the active jurisdiction of the Commission, perhaps this phase of the bill would not be necessary, this compulsory membership, which, obviously, is troubling some members of the committee.

Mr. WHITNEY. On that point, I would like to amplify my earlier answer relating to what the association can do that we cannot do.

If you will bear with me a minute, I would like to summarize for the record three paragraphs from this same section 15(A) that I referred to earlier:

The rules of the association in effect must assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors and in all other phases of the administration of its affairs. The rules of the association must provide for the equitable allocation of dues among its members to defray reasonable expenses of administration. The rules of the association must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commission, or other charges, and, in general, to protect investors and the public interest and to remove impediments to and perfect the mechanisms of a free and open market.

In discharging some of those obligations, one of the things that the NASD has consistently emphasized, which is an aid in our enforce-

ment, is their inspection of their members for compliance with the regulations and the net capital rules of the Commission. They are a very useful arm of inspection to the Commission in this specific area.

It is something that they do quite regularly.

In that respect, it relieves us of having to do that inspection job ourselves.

Mr. VAN DEERLIN. Is it possible, by the implementation of this proposed legislation, that any firms presently doing business would, by retroactive application, be put out of business?

Mr. WHITNEY. Again, as the chairman mentioned yesterday, it is possible that in setting up the qualification standards in the first instance, the NASD could provide what would be called a "grandfather" clause that would either place limitations on the applicability of the new qualifications standards to the existing membership or could give the existing membership and the persons in the different categories of employment a period of grace in which they could bring themselves into compliance with those standards.

The precise form which any such arrangement would take has not yet been a matter of discussion between the Commission and the NASD but it certainly would be if we had this legislation go through.

Mr. VAN DEERLIN. Not to be facetious, I suppose that by no stretch of the imagination could the NASD be referred to as a company union?

Mr. WHITNEY. I agree with you. I wouldn't be facetious, either, but I do think that you cannot overemphasize the impact in the last 3 years, the 3 years preceding the Special Study—I say 3 years, although actually it is a little longer than that—of the veritable flood of unqualified people that were able to come into this business.

At one point, I think, in the public hearings that the Special Study conducted in the spring of 1962, somebody made the point that it was easier to become a securities dealer than to become a barber. We have paid a high price for the lack of entry controls.

If you wish to say that, in dealing with that problem, you create a company union of some form, I think I, for one, will take the responsibility for saying that the Commission will deal with that problem as it must.

Mr. CARY. I think, Mr. Van Deerlin, that in view of the fact that H.R. 6789 contemplates the additional inclusion into the NASD of certain people, compulsorily, if you like, it is inevitable that an institution like the NASD—that is already quasi-public in character—will become more on the public side. In other words, it has that kind of responsibility. Therefore, it hasn't the private qualities of a company union, but it is increasingly, it seems to me, having to assume a public face.

Mr. VAN DEERLIN. This might be a matter of concern to the association, I should think, in approaching the normal functions of a trade association.

Mr. CARY. I think in working through this legislation, with which the NASD itself is in sympathy, the NASD has expressed its almost implicit willingness to assume this kind of responsibility and also to take additional responsibilities which they formerly have not had.

Mr. STAGGERS. Mr. Glenn.

Mr. GLENN. Referring back to the discussion of section 6(a) of the bill, having to do with the elimination of the intrastate exemption,

you mentioned in the discussion numerous times the use of the mails. I wonder if the broker-dealers made no use whatsoever of the mails, would they still be included in this section?

Mr. CARY. I think I will ask Mr. Loomis to speak to this point.

Mr. LOOMIS. If they did not use the mails and if they did not use interstate instrumentality, such as the long distance telephone, they would not be affected.

Mr. GLENN. Referring back to section 6(b), which proposes to relieve the SEC of proof of interstate commerce and use of the mails in disciplinary actions, what do you have to say about taking away from the broker-dealers the due process of law by taking away the right they have to assume that SEC is going to carry the burden of proof?

Mr. CARY. Well, we think in almost all instances you will find, even in a case where a man sends a confirmation to a customer who is across the street, the use of mails or the use of interstate facilities, such as the telephone.

Under those circumstances, we think that this proposal in this bill really does not go far beyond the realities of the situation. It is an effort to relieve us of the responsibility of having to go around and collect envelopes in which the mails are actually used, for example, with respect to sending confirmation or taking other action.

I therefore think that this is simply a recognition of the realities of the situation as distinguished from being a substantial step.

Mr. GLENN. But is not the language of the bill much broader than that, by relieving you of the responsibility of proving this and placing it on the broker-dealers in proving they are not doing it?

Mr. LOOMIS. This will be applicable primarily in fraud cases and it does not relieve the Commission of the burden of proving that a fraud was committed. All that we are relieved of proving is that a broker-dealer who has registered with us and who uses the mails in the course of his business used the mails or interstate instrumentalities in perpetrating the particular fraud.

I do not think, therefore, that there is a change in the burden of proof that is significant.

We still have to prove he committed the fraud and that, of course, is the crime, so to speak, at least we think it is the essential element of the crime. The courts have so held. The courts have held that the essence of the crime is not the sending of a letter but the perpetration of a fraud. That, we still have to prove.

Mr. GLENN. Thank you very much.

Mr. CARY. May I say just in conclusion on that point that the facts of the matter are, realistically, again, that if he hadn't used the mails or hadn't used the telephone, he probably wouldn't be in business. So we maintain that, therefore, this provision isn't extending our jurisdiction very far.

Mr. GLENN. Thank you.

Thank you, Mr. Chairman.

Mr. STAGGERS. Chairman Harris.

Mr. HARRIS. Mr. Chairman, I have a good many questions to ask at the proper time. I would rather the subcommittee members proceed until they have concluded. If the other members have concluded, I would like to go into several matters.

Mr. STAGGERS. Mr. Keith, have you any questions?

Mr. KEITH. I think probably I shall save most of my questions for other witnesses.

I would like to know, generally speaking, whether the SEC has actively supported the recommendations of the NASD with reference to the policing of the industry or if they have been, in fact, lenient with the membership of the NASD sometimes owing to the recommendations of the NASD.

Mr. CARY. I might have to ask Mr. Loomis to speak to that.

If you could make that clearer, I may be able to respond to it.

Mr. KEITH. In the questioning that I pursued yesterday, I referred to practices which revealed to have involved 2,000 investors, and you indicated that action was being taken in this area; that you were backing up the NASD.

Then, as I recall, the succeeding witnesses sort of backed away from the point of view you had expressed.

Mr. CARY. I think you were focusing on the Aqua Filter case. That case demonstrated an absence of supervision. Moreover, as I noted, H.R. 6789 explicitly makes a failure to supervise the basis of a disciplinary proceeding against a broker.

I said that I thought disciplinary action had been taken in Aqua Filter, but then on further checking I found that such was not the case.

The question, I take it, that you had asked is, does the fact that disciplinary action was not taken indicate that we have been unduly lenient? Is that the nature of your question?

Mr. KEITH. Did the NASD recommend action to you people which was not taken in that case?

Mr. CARY. In my opinion, no, but I will check. I will ask Mr. Loomis, in order to be absolutely sure.

Mr. LOOMIS. I do not know of any such incident. I think I would have learned of it.

The NASD can take disciplinary action on its own. It doesn't have to ask our permission.

I don't recall that it did take such action, and I don't believe that it recommended that we do so.

Mr. CARY. It is possible to have three concurrent actions taken; namely, by the NASD, by an exchange, and by ourselves. In recent times there have been at least two major instances where both we and a self-regulatory agency took action against the same firm.

Mr. KEITH. The thing that provoked the study, which caused you people to come here and ask for three-quarters of a million dollars and then later on $250,000 more, was to improve the climate, improve the regulations, if necessary, improve the law, if necessary, for the supervision of the sales of stocks and bonds in the marketplace.

Here was something selected by the Chief Counsel as an example of the kind of thing that was wrong in the business, and I think, from what little I know of the case, that there is sufficient law, rule, or regulation to have permitted action on the part of either the NASD or the exchanges or the SEC, and that somewhere some action should have been taken that would be a deterrent to similar situations developing in the future.

Mr. CARY. May I say that the case was selected by him not because of our failure of action but to demonstrate that there was a broader, shall we say, misconduct in the markets than he said we indicated existed in our letter of transmittal.

Now, as to whether or not disciplinary action would be taken, we were keenly aware of this particular case at an early stage. That is one of the reasons, of course, that it is in this Special Study.

We have not, in this particular situation, taken any action ourselves. For one reason, as I indicated earlier yesterday, the firm paid every customer who had purchased under a misrepresentation. There was this reimbursement and, therefore, the matter was pretty largely, from an economic standpoint, settled up.

Mr. KEITH. Was wide publicity given to this payment to the 2,000 investors who had bought stock as a result of the misrepresentation?

Mr. LOOMIS. Yes, it was reported rather extensively in the newspapers.

I might mention that just looking again at the Study Report on this incident, they report that the firm in question itself disciplined its employees that were involved, that the New York Stock Exchange, of which the firm was a member, conducted a fairly extensive investigation, took disciplinary action against one salesman and found there was insufficient basis for disciplinary action against the firm or certain other people.

Mr. KEITH. Thank you very much, Mr. Chairman.

Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Harris.

Mr. HARRIS. Mr. Chairman, I have listened with a great deal of interest to your presentation and the discussions that have occurred since. I do not think anyone is unmindful of the importance of your proposal and of the matters we have under study and consideration. You and those on the Commission with you, and your staff, have done an exceptionally good job from your viewpoint and responsibility and you have certainly done a tremendous amount of work on this entire problem.

I, for one, would like to express my appreciation for the work that you have accomplished, the splendid statement that you have given outlining the work of the Special Study with which we were familiar, and the recommendations growing out of the study, both for legislative action and for action of the Commission through its rulemaking power.

I think the results of the study and what the Commission already has done in the way of internal reorganization and proposals, and what already has been done by the industry itself, which have been fully discussed, in changing the practices and proposals for action ahead, clearly demonstrate the value of the study and the wisdom of this committee and the Congress in providing for it some 2 years ago.

As you have indicated, the situation at that time, as well as the fact that there had been no overall review of the securities markets for 25 years, seemed to cry out for a study in the light of experience under the securities law. So, in taking this opportunity to commend the Commission for the very outstanding job it has done in meeting the tremendous task and the duties assigned to it, I know you must be proud of the great job turned out by Mr. Cohen, whom the Commission selected to head the work, and, of course, by the associates that he had in this undertaking.

Let there be no doubt in anyone's mind that the confidence expressed in entrusting this study to the Commission by this committee was fully

warranted. I believe it has had the approbation of the industry itself, generally, and those who were interested and are interested in this field.

It seems to me, Mr. Chairman, that this study and the activities of the Commission now in carrying out the recommendations arising from the study sharply point up the kind of cooperation, which can be achieved by joint efforts of the committee, the Congress, and of a major regulatory agency such as yours, which administers powers delegated to it by the Congress through legislative activity, meaning, of course, you are performing a function for the Congress that it is not practical for the Congress to do itself.

It is needless to emphasize what we refer to as the independency of these agencies.

I wish also to express my appreciation of the manner in which you at all times have kept us informed of your progress. I know you have conferred with me innumerable times. I know you have conferred with Mr. Staggers from time to time, as well as other members of the committee, and with the committee staff.

Your apprising us of these problems as they have developed in the course of your work has, I think, contributed greatly to this effort. Of course, you have been very definitive in the manner in which you have written to us concerning the Commission's comments upon the adoption of its own of the Special Study recommendations, and of how you intended to meet such recommendations.

You see, there are so many people, including many of the news reporters, who do a very good job from their viewpoint but know nothing about what is going on, in view of those of us, like yourself, me, and other members of the committee, who are working day and night on these problems in the public interest. Sometimes I think I am going to make a proposition to some very fine newspaper reporter that they take a leave some time from their duty and come with us on this committee and stay with us a while and find out a little bit about what actually goes on as to the actual responsibilities that we have, instead of speculating so much and getting the public sometimes misinformed about what the facts are.

While I naturally was disappointed that the study could not get into certain fields, which, as you know, we did contemplate from the start, I have fully realized that the job was much larger than we thought at the outset, even than Mr. Mack, chairman of this subcommittee at that time, and who did give a lot of study to this problem, had thought. So the selection of specific areas which we have discussed from time to time had to be made.

I have also recognized that the time allowed was a factor, and that pulling together the results made it necessary to extend the reporting date.

With all of this, I still am sure that you and your colleagues have a sense of satisfaction from this challenging task that you have endeavored to perform so well. I personally am glad to have your report on what you have done to establish priorites.

I asked you briefly about it yesterday.

And on rulemaking, what the exchanges and the National Association of Securities Dealers are doing.

Sometimes I wonder if these self-regulatory organizations are as fully cooperative in rulemaking as they appear to be in the area of your legislative recommendations.

Do you have any comment on that?

Mr. CARY. Well, sir, that is a very broad question that I may have to give a broad answer to.

By and large, we are at the formative stage right now on these big, tough problems as to which I have mentioned the existence of priorities yesterday. The self-regulatory agencies have formed committees. They have, you know, in a number of instances, retained special advisory groups to analyze out the recommendations we have made.

I firmly believe in discussing this out with the industry in order that we can arrive at a responsible solution. I don't have the illusion that here will be unanimity of opinion with respect to all of these rules that we may ultimately come out with.

Mr. HARRIS. I have been very strong on this matter of self-policing or self-regulation, whatever term might be used to describe it, not only with your Commission but with others.

Recently I said to the Chairman of the Federal Communications Commission, even though I was very strong for this principle of self-regulation, that I was certainly far from being satisfied with some of the actions of the industry, itself. I mean that.

We are right now in the throes of trying to write an overall transportation policy. I must say that I am greatly pleased at the reaction of the industry generally and its cooperation, where you have so many of these competitive elements as we do in this matter.

If the industry, who are so closely associated with these major regulatory agencies, are going to expect us, in our responsibilities, to follow a principle which we believe in, then I think it is incumbent upon the industry, by its action, to show us that the confidence is well placed.

In order to be successful in these endeavors, I think sometimes we have to overlook some of these personal things of personal views. It is a give-and-take proposition to try to find out what the real problem is and to try to get in to meet it.

As an example, you have the problem of self-regulation versus antitrust laws. We have the same problem in ratemaking with reference to exemptions versus antitrust laws. I think we have to meet it head on.

You have not done that yet; have you?

Mr. CARY. No, sir. I suppose you are now referring to the consequences of the *Silver* case.

Mr. HARRIS. That is true.

Mr. CARY. We have had a number of discussions and exchanges of correspondence with the exchanges, primarily the New York Stock Exchange, on that matter. We have not arrived at any final conclusion as to what should be done, which, of course, primarily involves the matter of review. That is, the implication of that case is the question of review by the SEC of actions taken, primarily in the disciplinary field, by the New York Stock Exchange. We have not gone that far. We have inquired and we have exchanged correspondence. The question is still under discussion at this time.

Mr. HARRIS. Let me review briefly. These things are so highly technical I do not think we can go over them too much. I think it is more important that we understand them, more than anything else.

Let me review briefly with you just what you propose in these bills in a different way than you have given us.

No. 1, the bill extends to issuers of securities traded in over the counter some of the same requirements that apply to issuers of securities which are listed on an exchange?

Mr. CARY. That is correct, sir.

Mr. HARRIS. More specifically (a), registration requiring disclosure of certain information, including insider interest and financial statements, as are included in section 12?

Mr. CARY. That is correct, sir.

Mr. HARRIS. And, (b), periodic reporting as provided in section 13?

Mr. CARY. Correct.

Mr. HARRIS. (c), Information, including financial statements to accompany proxy solicitations, or if no solicitations supplying the information as provided in section 14?

Mr. CARY. Proxy rules will apply; yes, sir.

Mr. HARRIS. (d), Reporting of changes of stockholding of the issuer's officers and directors, or 10 percent stockholders of the issuer, and making and short-term profits resulting from transactions in the stock subject for a period of 2 years to recapture by the issuer.

Mr. CARY. That is section 16 of the act, sir.

Mr. HARRIS. In the second place, you propose to strengthen regulation of over-the-counter broker-dealers?

Mr. CARY. Yes, sir.

Mr. HARRIS. That will be by (a) requiring all to belong to a registered securities dealers' association.

Mr. CARY. Yes; that is correct.

Mr. HARRIS. That means to the National Association of Securities Dealers.

Mr. CARY. They may. We have been asked this. I think the question came from a large mutual fund asking whether or not an organization could be formed comparable to the NASD and our answer was that it could be.

Mr. HARRIS. But it has not been.

Mr. CARY. It has not been, that is correct.

Mr. HARRIS. And you only have one?

Mr. CARY. We only have one at this time under section 15A.

Mr. HARRIS. The Commission has certain jurisdiction over the NASD?

Mr. CARY. Yes, sir; under section 15A, we have very substantial review powers.

Mr. HARRIS. What do you think would happen if the Commission were to encourage another association?

Mr. CARY. I think then it would be a question of, first, whether or not there is a group large enough that it would want to form a separate one and second, whether the group would want to incur the expenses involved in such an organization.

I think starting up another agency gives rise to all those additional overhead and other items which a group would not have if they joined the NASD. I cannot say whether or not any group at this time will, or even would, if we encouraged it strongly, form a separate

organization. I do not know. I do know that there is some thinking in that line or they wouldn't have asked this question.

Mr. HARRIS. But if it did, it would increase your workload, would it not?

Mr. CARY. It would increase our workload of supervision because we would be supervising two organizations instead of one.

Mr. HARRIS. In the second place, you would strengthen regulation of over-the-counter broker-dealers by requiring such association to establish standards of training, experience, and competence for members and employees, and capital requirement for members.

Mr. CARY. That is correct.

Mr. HARRIS. You do not have that authority today?

Mr. CARY. In general, the answer is, "No, we do not," except that I do think we probably have some powers at the moment with respect to setting minimum capital requirements, which we may and can exercise without the additional legislation here authorizing it.

Mr. HARRIS. This gives you, the Commission, as a matter of fact, unlimited powers or unlimited authority over the associations, does it?

Mr. CARY. We have very substantial authority. I don't know whether I would call it unlimited, Mr. Chairman, but it is very substantial in terms of abrogating their rules and in terms of review of their disciplinary actions and the like.

So we have a very broad oversight authority under section 15(A) of the Securities Exchange Act.

Mr. HARRIS. I think, in order that everybody might understand it, if we do not know, that it seems to me that where the agency, the Commission, has the authority to require the association to establish certain standards of training, experience of personnel, "competence"—and that is a good term, too—for members and employees, in other words where you have this broad authority over the personnel itself, and then on top of that the capital requirements, that is a pretty big chunk, isn't it?

Mr. CARY. That is correct, and the objective is to set certain minimum standards which have never been observed in this industry so that we can have a more responsible and more qualified group engaged in the business.

We have found from the period we have just been through recently that, if we start at the threshold with higher standards, we anticipate there will be very substantial improvement in investor protection.

Mr. HARRIS. This is applicable to over-the-counter broker-dealers; is it not?

Mr. CARY. This would be applicable to broker-dealers generally.

Of course, there are already rules applicable to those who are members of exchanges.

Mr. HARRIS. Are they as far reaching as this?

Mr. CARY. In many instances they are farther reaching, that is correct.

Mr. HARRIS. I do not know how they could be any farther. If you control the personnel and the capital, where else can you go?

Mr. CARY. All I meant, sir, is that I would assume that if this bill went through, with your encouragement, that under those circumstances you would find a minimum capital requirement by the NASD lower than that applied by the New York Stock Exchange to its members. That is what I meant.

Mr. HARRIS. I am not talking about that. I am glad you said it. That brings me right to the point that I want to pinpoint. You are trying to explain what you would do under this broad authority, and I know you are honest in it, and I know that is your intention. But my attention has been called, by a letter from the Attorneys General Association that I have received, to the broad general powers given to a Commission with a certain intention today, and what another Commission may do 5 years from now. I personally feel that we ought to do just what we recommend and what is intended. That is what you intend to do today, but I think the industry, and everybody else, the associations and all, should understand that these powers are wide enough that, when you are gone and the members of the Commission are gone today, there might be another Commission that might decide they want to do something else, and there is nothing to prevent them from doing it.

Mr. CARY. Mr. Chairman, we still have the supervision and oversight of the Congress.

Mr. HARRIS. I have been engaged in that business for the last 10 years and I am getting a little tired of it, to tell you the truth about it.

Mr. CARY. We are keenly aware, every day, of your sitting over us, and that it is quite proper and necessary. We are in turn sitting over these associations; it is quite necessary.

Mr. HARRIS. All of us realize our responsibility in the field. But sometimes you get to the point that you might be trying to encroach upon what is really the prerogative of someone else. But we have to face all these facts when the information comes to us. It piles up pretty fast from this side of the business.

Mr. CARY. It is hard to set in precise statutory terms, Mr. Chairman, for example, what experience should be required of a branch office manager. That is why the bill is written in broad terms. But a standard of experience would be fixed by a rule of the NASD which would be examined and, in effect, approved by us.

Mr. HARRIS. A branch office manager in one place may be required to have more or less experience than a branch office manager in another place, is that what you are trying to say?

Mr. CARY. What I was really thinking of was that firms shouldn't be sending, as they did in a case which we had some time ago, a manager of a health shop to become a branch office manager of a brokerage firm.

What we are trying to do, therefore, is to establish minimum standards as distinguished from really drawing these differences between different branches.

I grant you that it might be that a huge branch in one place should require a man with greater competence than in another place. But that isn't what I had in mind.

Mr. HARRIS. In the third place, you propose to strengthen regulations of over-the-counter broker-dealers by permitting the Commission in a disciplinary action to proceed directly against the employee of a broker-dealer in lieu of action against the firm, and to permit the Commission to employ sanctions thereto, such as suspension, short of revoking registration altogether.

Mr. CARY. We would be able to proceed directly against individuals, whereas, up to this time, we had to go through the firm in order to get to an individual.

Mr. HARRIS. Finally, you would permit the Commission, in the case of broker-dealers registered with the Commission, to proceed directly against any activity of the broker-dealer without the necessity for proving that the mails or instrumentalities of interstate commerce were used in a particular proscribed transaction?

Mr. CARY. That is correct, sir.

Mr. HARRIS. What is an over-the-counter transaction?

Mr. CARY. An over-the-counter transaction is any transaction that is not on the exchange. It is that whole wide area of securities transactions that are not conducted on exchanges.

Mr. HARRIS. It does not necessarily mean that literally it has to be over the counter?

Mr. CARY. No, sir. It is much broader than that.

Mr. HARRIS. It could be done by telephone?

Mr. CARY. Yes, sir.

Mr. HARRIS. Did you say you could not tell how many companies would be involved in your statement of 750 and 500 stockholders?

Mr. CARY. As I recall, it is 3,100 with respect to the 750 test, Mr. Chairman, and it would be 3,900 with respect to the 500 test. Perhaps I ought to point out that included in the 3,100 category are 400 bank stocks and 1,500 companies which are already partially subject to our jurisdiction through section 15(d). In other words, they have issued securities at a previous time and the total amount of securities offered and outstanding was $2 million or more. These companies are required to file information, although they are not subject to the proxy requirements nor are they subject to the insider trading provisions at the present time.

Mr. HARRIS. You previously suggested 300 stockholders and $3 million of assets, didn't you?

Mr. CARY. At one time, I do not know which year. When this legislation came up previously, we did have different tests; indeed, the Special Study of the Securities Markets recommended that we use a 300 test rather than the one we have chosen. But we felt that weighing the needs for investor protection versus the costs of administration, and the problems that would arise at the 300 level, we ought to go up to 500 as a minimum. We are starting, as you know, with 750 for the first 2 years.

Mr. HARRIS. What is your reasoning for the Commission not adopting the study recommendations and accepting your own?

Mr. CARY. The decision was made by us after talking at length with the Special Study. We felt that use of a 300 shareholder test would probably involve a very large number of small companies as to which we should not be spending our initial efforts and time. As a consequence, we thought that at the 500 level we would be hitting companies of substantial size as well as a very substantial public interest in terms of security holders. We just chose a different breaking point.

Mr. HARRIS. Did this come as a result of your circulating a draft to the industry and getting comments thereon?

Mr. CARY. When we first took this matter up with the industry—and you are quite right, yes, sir—I think we started by submitting to

the industry the study proposal of 300. We were not sure, ourselves, but we started at that figure as a basis for discussion.

After discussions with them and after our own independent analysis, we decided that the 500–750 level would be satisfactory.

I would like Commissioner Cohen to elaborate on this point.

Mr. COHEN. I think the chairman has covered the ground substantially. I would only reemphasize that the Commission considered the administrative burden on companies that might be affected by the bill, the administrative burden on the Commission, and the public interest factors.

We considered trading activity, the number of transactions in the stock of companies within this category, and arrived at the decision that we did after weighing these various factors.

Mr. HARRIS. Let's get a little more specific. I believe you advised the committee yesterday of the number of banks that would be included.

Mr. CARY. Yes, sir.

Mr. HARRIS. And also of your decision to let the other agencies having to do with banks administer this phase of it?

Mr. CARY. Yes, sir.

Mr. HARRIS. How many stock insurance companies would be included?

Mr. CARY. Approximately 400, sir.

Mr. HARRIS. That would be included?

Mr. CARY. That is correct; about 400 would be included. Of these, 130 already are filing reports pursuant to 15(d), which I mentioned earlier.

Mr. HARRIS. On a voluntary basis?

Mr. CARY. Not on a voluntary basis. Pursuant to section 15(d) of the Securities Exchange Act which requires, Mr. Chairman, that when a company registers a public offering of securities under the 1933 act and the amount offered and outstanding is $2 million or more, the company must thereafter file periodic reports. Therefore, 130 insurance companies do presently file reports, but they are not subject to the proxy requirements, nor subject to the insider trading provisions.

Mr. HARRIS. That would mean, then, about 270 would be brought in under the supervisory authority of the Commission?

Mr. CARY. That is our best estimate; yes, sir.

Mr. HARRIS. I gathered from your statement that these insurance companies primarily that you bring under would come from the Southwest.

Mr. CARY. I didn't say that, sir. I quoted an annual report of the SEC of some time ago that there had been a large amount of promotional activity in the insurance field which centered in the South and Southwest; that is correct. But, as to the quantity, I am not able to give you a regional size of the whole group—as to how many will be covered from that area as distinguished from another area.

Mr. HARRIS. My question was: Why is it that certain of these companies with promotional activities in the South and Southwest are not covered now, and the companies in the other areas of the country are?

Mr. CARY. I don't know whether they were or were not previously covered under section 15(d). I don't think we can really give an answer to that question.

As I said, I was there quoting. The annual report was relating itself to certain of the commission's enforcement problems.

But I don't say one way or another whether the ones in the East, for example, were already filing under 15(d) and the ones in the South and Southwest were not. I just don't have an opinion on that.

Mr. Cohen might speak to this further.

Mr. COHEN. I might add that many of these companies were companies organized within a particular State and limited their sales activities to that particular State. They relied on the intrastate exemption from the Securities Act and, therefore, have not been subject to our jurisdiction heretofore. A great many of those companies, however, did, in fact, make a public offering and they are included in the 171 reporting companies that the chairman mentioned earlier.

Mr. HARRIS. Did any of them move from the East or the West or some other section into these various localities for the purpose of becoming exempt?

Mr. CARY. No, sir; I don't think any of them would move in that way for that purpose. The exemption on which they would rely, Mr. Chairman, presumably would be the so-called intrastate exemptions, and they would have sold their stock only within the particular State.

Mr. HARRIS. What I am trying to find out is why is it that this area is subjected to such greater promotional activity than any other? I am trying to find out. If I can help build up the insurance business or any other business in the South or Southwest, I want to do it. If there is any attempt to drain the business from there to some other section of the country or to put restrictions because they are building up, then I want to know that.

Mr. CARY. Mr. Chairman, I don't think this was draining it from any other section. I think it was simply the product of new business enterprise growing as it has, with the growth in the Southwest and the South, itself. I don't think it has been anything more than that, to my knowledge.

Mr. HARRIS. That should be good incentive for other people to come there, whom we would welcome.

Mr. CARY. Indeed it should be. This is in no way a discouragement. We believe that if reliable and accurate information becomes publicly known—in other words if the public knows about these companies and knows more about the securities—you are going to have broader, rather than narrower, investment.

Mr. HARRIS. I am doing all I can here to make it become publicly known.

How many industrial companies would you include in this activity?

Mr. CARY. We would include, sir, a total—may I go back over the figures on page 17 of my first statement? On the 750 test, operative for the first 2 years, it would be a total of 3,100 companies, which would include banks and industrial companies, and insurance companies. So if we subtract 400 banks, Mr. Chairman, and let's say 400 insurance companies, it would be a total of 2,300 at the outset. Then it will go about 600 industrial companies when you get to the 500 shareholder test.

Mr. HARRIS. If banks and stock insurance companies are to be covered by this extension, why not building and loan associations?

Mr. CARY. Well, sir, we do not have any jurisdiction over building and loan associations generally, and I though they were subject to other Federal regulatory agencies. May I ask Mr. Cohen to speak to that and maybe Mr. Loomis? I simply haven't given that any thought.

Mr. HARRIS. Did your study deal with that subject at all?

Mr. CARY. It did not; no, sir.

Mr. HARRIS. I want to know why it didn't.

Mr. COHEN. This is another area that the study group did not reach because of the number of other areas they were looking at. In the case of building and loan associations, and that type of organization, frequently the interest in the association is limited to a person who is a member of the association, with savings-type interest, in an association from which he may also borrow funds. There are various kinds of these organizations; when organizations of this kind sell stock as a stock investment, they are within the purview of the Federal Securities Act, as is proposed in this bill.

This is a matter which is under discussion among the various agencies concerned with these organizations.

Mr. HARRIS. I think some thought and attention should be given to the competitive element in these fields. I don't care whether they call it a mutual, a building and loan association, a stock company or what it might be. If there are going to be certain requirements—and I must confess that I know as little about the stock business and the securities business as probably anybody on this committee, but I am trying to find out—from the standpoint of the competitive element, it seems to me that where it is so highly technical and is so highly competitive, that thought and study should be given to all the competitive elements.

If you have restrictions that are going to hold one group down and turn another group loose, you know what is ultimately going to happen.

Mr. COHEN. If I could add to that, normally in many of these organizations the person who has an interest in the association is in the nature of savings—a savings interest. He doesn't have anything that he can usually transfer, as he can a share of stock, but in more recent years there has been a development in this area whereby stock in these organizations has been created for sale to the public as an investment. It is in this particular area that attention is being given to them within the purview of the securities acts.

Mr. HARRIS. I realize if there are any building and loan people here, or any mutual people here, they will probably be seeing me later.

Are farm cooperative associations covered by this proposal?

Mr. CARY. May I ask Mr. Loomis to speak to that?

Mr. LOOMIS. We have had some discussions as to this matter with the Department of Agriculture and with the National Council of Farmers Cooperatives. Our conclusion is that it would be very unlikely if any farmers' cooperatives would be subject to this bill. However, they couldn't give us complete information as to how all farmers' cooperatives in the country are organized and financed.

Apparently there are a variety of ways in which this is done. We think the bill wouldn't reach them. If we should find an unusual one which might technically come under the bill, as I advised them, I anticipated that the Commission would exercise its exemptive powers

under the bill to let them out, because in framing this bill we were not interested in reaching farmers' cooperatives.

Mr. HARRIS. Mr. Loomis, you are supposed to provide the legal advice to the Commission; are you not?

Mr. LOOMIS. Yes, sir.

Mr. HARRIS. Are you telling us that the Commission can exempt people from this that are not exempted under the provisions of the act itself?

Mr. LOOMIS. Yes, sir. The bill does grant to the Commission specifically the power to exempt certain types of organizations if it finds that they are not the type that was intended to be covered.

Mr. HARRIS. I have a letter from the president of the Stock Exchange Commission in Richmond, Va., which raises that question, which I was going to get to after a while. In my judgment, the advice which you have just given is completely contrary to their position. I am inclined to believe that perhaps they are right. I am going to give it to you, even though you have already written one letter on it. It appears to still raise some question. I am going to give it to you before this is over and get a review.

Mr. LOOMIS. Is this a farmers cooperative?

Mr. HARRIS. No, it is the local exchange. But the same principle is involved. You say, "I may control them or I may not control them." If it develops technically that they are controlled, "then we give them an exemption," on your own, which means nothing to us. Congress has given you such broad powers that you exempt who you want to or who you don't want to, which is one of the things that I raise as a matter of policy.

I think we ought to have more information as to just what we are doing here. That is my position on it. I don't want to find myself later on having farm organizations down my throat when they say that, "We stayed out of it because we didn't think we were included," and now we have a letter dated July 17 to Senator Robertson, chairman of the Senate committee, in which you state that they are covered.

Mr. LOOMIS. I didn't state that they were covered. We stated that there is little or no trading in the equity securities of farmers cooperatives. We do not have sufficient information to determine definitively whether or not there are any farmers cooperatives which might be subject to the bill. This was simply because we didn't know how they were all organized and we couldn't find out. But we went on to say that assuming, however, the particular characteristics of these organizations and the lack of trading interest in their equity securities, it would appear that if any farmers cooperatives should turn out to fall literally within the sections of the bill referred to, it would be appropriate for the Commission to exempt them pursuant to the powers provided in section 12(h) of the act.

Mr. HARRIS. Meaning that you think it is very likely that some of them or all of them could be covered.

Mr. LOOMIS. No; the entire letter indicates that it is very unlikely that any of them would be covered. But we can't say definitely, for lack of information, whether or not one or two——

Mr. HARRIS. Let me read this sentence, which is yours, and which is signed by you.

"It appears, however, that farm cooperatives do issue common stock and preferred stock."

(The entire letter follows:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 17, 1963.

Re application of S. 1642 to farmer cooperatives.

Hon. A. WILLIS ROBERTSON,
Chairman, Committee on Banking and Currency,
U.S. Senate,
Washington, D.C.

DEAR SENATOR ROBERTSON: A question has arisen as to whether or not certain farmer cooperatives might become subject to the disclosure, proxy solicitation and insider trading provisions of the Securities Exchange Act by reason of the amendments to that act provided in S. 1642. At the suggestion of Mr. Otto Lowe of your staff, representatives of the Commission conferred with Mr. L. James Harmanson, Jr., general counsel of the National Council of Farmer Cooperatives, and Mr. Raymond J. Mischler, Deputy Director of Research and Operations, Office of General Counsel, Department of Agriculture, with respect to this matter and Mr. Mischler has recently furnished to us certain reports of the Department of Agriculture with respect to the financing of farmer cooperatives.

Section 3(a)(5) of the Securities Act of 1933 exempts from that act "any security issued by a farmers' cooperative association as defined in paragraphs (12), (13), and (14) of section 103 of the Revenue Act of 1932." There is no corresponding exemption in the Securities Exchange Act of 1934. This has not, however, had any practical effect since no securities of any farmer cooperative are listed on any national securities exchange and, insofar as we can determine, there is little, if any, trading in the equity securities of any such cooperative in the over-the-counter market.

It appears from the information supplied by the Department of Agriculture that farmers' cooperatives obtain necessary capital in a variety of ways which include borrowings as well as equity capital. Equity capital is represented by various types of interest, many of which are not characteristic of ordinary corporations. The most important single source is so-called allocated capital credits without maturity dates. It appears, however, that farmer cooperatives do issue common stock and preferred stock. These securities differ in various ways from the common and preferred stock issued by conventional corporations, but they might nevertheless constitute equity securities within the meaning of section 3(a)(11) of the Securties Exchange Act of 1934.

We understand that the stock of farmer cooperatives is customarily held by their farmer patrons and that there are often various restrictions upon the transfer of these securities and upon the returns which may be paid upon them. For these and other reasons there is little or no trading in the equity securities of farmer cooperatives in the over-the-counter market. We do not have sufficient information to determine definitely whether or not there are any farmer cooperatives which might fall literally within section 12(g) of the Securities Exchange Act of 1934 as added by section 3(c) of S. 1642. Assuming, however, the particular characteristics of these organizations and the lack of trading interest in their equity securities, it would appear that if any farmer cooperatives should turn out to fall literally within the sections of the bill referred to, it would be appropriate for the Commission to exempt them pursuant to the powers provided in section 12(h) of the act as added by section 3(d) of the bill.

Sincerely,

PHILIP A. LOOMIS, Jr.
General Counsel.

Mr. LOOMIS. Some of them do; yes.

Mr. HARRIS. Then they are covered?

Mr. LOOMIS. If their common stock and preferred stock is of such a nature as to constitute a security within the meaning of the act. That is not necessarily clear, because, notwithstanding the name, it may in fact, be a membership certificate; and if also there are sufficient stockholders and sufficient assets.

Mr. HARRIS. In other words, you think that the principle involved here should be that the Congress should give you broad authority to include them or to except them?

Mr. LOOMIS. We feel that the general standards as to the types of securities to be covered are set forth by Congress, generally being securities in which there is trading and investing interest, and that we should have authority to exempt a company which might happen to come within the literal language of the bill but not within the intent of Congress.

Mr. HARRIS. I wish I could depend on that. That is no reflection on you, but I have observed these things over the years, that at one period there might be an interpretation of what Congress intended and in another period an entirely different interpretation.

I am pretty strong on knowing what we are doing, myself. I know we got into one of these reversible things with the Communications Act under the MacFarland amendments, back in the latter 1940's, and it took us 10 years to undo what we did there, with all the help of everybody that helped to do it, including the Commission, itself.

Mr. CARY. Mr. Chairman, if there is any question about this I think we would supply a letter at your request making it much clearer that that exemption would be granted.

Mr. HARRIS. I wish you would review that so that we can make it clear one way or the other. What I want to do it to have an understanding so that everybody knows where they stand.

Mr. CARY. The premise in Mr. Loomis' letter is that he would not anticipate that farmer's co-ops would be covered and, if covered, we can exempt them. We can state that much more precisely if you would wish that in the record.

Mr. HARRIS. I can't go along with the comment that you made a moment ago to Mr. Curtin, that you extend your jurisdiction just a little bit. As I gathered, you had just a little bit of jurisdiction and then you are extending it a little bit more.

I know precisely how that is. With these broad general terms, it does not go a little bit. You either do or you don't. We draw the line and have the limitations. We want to have this accomplish just what is to be done, and just so clearly so that there will be no problems.

Well, we cannot eliminate problems, but we want a minimum of problems in connection with its operations.

It is noted that under the proposal for registration of companies whose securities are traded over the counter, the Commission is given the authority to classify issuers and prescribe requirements appropriate for each such class. Is that your understanding?

Mr. CARY. Yes, sir.

Mr. HARRIS. Will the Commission extend this classification further than section 12 of the Exchange Act, that is, will issuers be classified for the purpose of the act of 1933 either as far as form goes in registration, or as far as exemptions are concerned under section 3(b) of the act?

Mr. CARY. Yes, sir; as we begin to face up to this large number of companies newly under our jurisdiction, we will have to have a series of different forms applicable to different types of companies. We may classify reports by industries or amount of assets.

Mr. HARRIS. What does it mean in connection with this business by the term "inside information"? That is one I have been wanting to get in on for some time.

Mr. CARY. Well, sir, as I recall, the term "inside information" is not used in the statute, but it is the theoretical or rational basis on which the so-called insider trading provision is founded.

Section 16, which you have already referred to, deals with insider transactions and relates to officers, directors, and 10-percent shareholders of companies. These are the people who are generally familiar with information that the public may not know about a company.

Section 16 requires the "insiders" to report their security holdings of any company in which they are officer, director, or 10-percent shareholder and report their purchase or sale transactions. The public then has information as to the amount of their trading in the security in respect of which they could be deemed to be an "insider."

Mr. HARRIS. Mr. Funston, I believe, testified to the committee, and I think these are his words, "We think that the insider trading ought to be, instead of filed by the 10 of the following made, filed within 10 days of having been made. There ought to be some teeth put into the law, which there aren't now."

Is that true?

Mr. CARY. In other words, he would want to make it a more immediate reporting device. I will ask Mr. Cohen to speak to that.

Mr. COHEN. I think that is right. The present statute requires that as to certain persons a report is filed 10 days after the month in which the transaction is effected. I think Mr. Funston suggested that the report be made 10 days after the transaction is effected.

This question raises the whole host of questions with respect to section 16 of the 1934 act, which would arise if this entire subject was taken up. The Commission very deliberately in this proposal now before you has avoided opening up that section because it does involve a great many problems as to which there are very strong feelings, and I believe it woud involve a consideration of the basic philosophy of the section, and a number of decisions in the courts in the past 30 years.

The industry feels very strongly about how this statute has been interpreted by many of the courts, and I believe they would have innumerable proposals in this area. The Commission felt that this was an entire subject that might be treated independently of the present proposals before you, and that it perhaps should first be explored more fully under the Commission's exemptive powers now contained in that section.

Mr. HARRIS. That is the reason there is no recommendation at this time?

Mr. CARY. Yes, sir.

Mr. HARRIS. In that regard, I wonder if it would not be advisable to include in the record at this point the correspondence between the Commission and the chairman of the subcommittee with reference to this problem. I think probably it would help make this record clearer.

Mr. STAGGERS. It shall be included.

(The information referred to follows:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., June 17, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CHAIRMAN: I have noted that your recent edition of the purchases and sales of officers, directors, and insiders of corporations in their own securities sets forth a number of transactions in Transportation Corp. of America stock extending back as far as 1960 made by O. Roy Chalk et al.

Is there some recent development which would have led to the filing of this information at this time or is this information which should have been filed previously within a 10-day period at the end of each calendar month?

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., June 26, 1963.

Hon. HARLEY O. STAGGERS,
House of Representatives,
Washington, D.C.

DEAR MR. STAGGERS: This is in reply to your letter of June 17, 1963, relating to the filing of reports of transactions in the common stock of Transportation Corp. of America by O. Roy Chalk.

There is enclosed a memorandum on the matter prepared by the Division of Corporation Finance of the Commission which I trust you will find helpful.

Please do not hesitate to communicate again if we can be of further assistance in this or any other matter involving the Commission's work.

Sincerely,

WILLIAM L. CARY, *Chairman.*

Enclosure.

MEMORANDUM PREPARED BY THE DIVISION OF CORPORATION FINANCE OF THE SECURITIES EXCHANGE COMMISSION WITH RESPECT TO A LETTER DATED JUNE 17, 1963, FROM THE HONORABLE HARLEY O. STAGGERS

Congressman Staggers has asked why certain transactions of O. Roy Chalk and others in the common stock of Transportation Corp. of America (TCA) which occurred as long ago as 1960 were not reported to the Commission at an earlier date.

This is information which should have been reported within 10 days after the close of each month in which any change occurred in Mr. Chalk's direct or indirect ownership of TCA's equity securities. The recent delayed filing of this information came about in the following manner: TCA filed proxy material with the Commission on April 8, 1963, relating to its forthcoming annual meeting of shareholders. The number of shares of TCA shown to be directly held by Mr. Chalk differed from the number shown on Mr. Chalk's ownership reports. The staff learned from counsel for Mr. Chalk that his holdings of TCA common had changed in 1962 due to stock dividends, exchanges, and gifts. Counsel claimed that they did not realize that such changes in ownership should be reported.

During the discussion with representatives of Mr. Chalk on the question of his direct holdings of TCA common stock, it was learned that certain corporations controlled by Mr. Chalk had been buying TCA securities beginning in October 1960. These transactions had not been reported and counsel again stated that they were unaware that transactions by these corporations were required to be reported. Mr. Chalk was requested to report all of these changes in his direct and indirect ownership of TCA common stock, whereupon he filed reports covering the transactions which were described in the May 1963 Official Summary of Security Transactions and Holdings.

Some 50,000 persons are presently subject to these reporting requirements and more than 40,000 reports are filed each year, most of them within the prescribed period. Some information, like that under discussion, is not reported within the prescribed period and is reported only after the necessity for doing so is called to the attention of the reporting person by the staff as the result of examination of corollary filings, as in the instant case. In this connection, it should be noted that no specific penalty is provided in the statute for the late filing of section 16(a) reports. Section 32 of the Securities Exchange Act provides penalties for willful violation of any provision of the act, but in only a few instances has it been found that failure to file section 16(a) reports within the prescribed period was willful.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., July 2, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR CHAIRMAN CARY: I appreciate your letter of June 27 enclosing a memorandum prepared by your Division of Corporation Finance respecting the transactions in the common stock of Transportation Corp. of America which were only recently filed with the Commission.

Thank you for your response to my inquiry and for your indication of your having been satisfied with the representations made to you as to the lateness of the filing. You will appreciate, of course, that I raise the question simply owing to the fact that just a few years ago we had a rather unfortunate incident of another type of filing which had not been made for many years without the Commission's having checked it out.

Insofar as the general subject of reporting under section 16(a) is concerned your memorandum raises more questions than it has resolved.

I do not know whether or not the reference to the fact that some 50,000 persons are subject to the reporting requirements and more than 40,000 reports are filed each year means that this is presently a burdensome task for the Commission and one on which it does not have a followup for seeing whether the reports are filed within the prescribed period, especially in the light of your pending legislation for increasing the number of reports that would be filed in this field.

Again, your memorandum refers to the fact that there is no specific penalty provided in the statute for late filing of section 16(a) reports and raises the question in my mind whether the Commission had considered whether it should recommend that there be penalties for failure to file required reports. In such connection, of course, section 16(a) is closely tied in with 16(b) and 16(b) provides for the recapture of profits made by insiders with a 2-year cutoff. Where such recapture is, of course, dependent upon knowledge of the transaction the late filing of required reports may be of some moment.

In this connection also I take it that your pending legislative recommendations have given careful consideration to the matter of late filing such as occurred on some of your corporation annual reports.

In this connection also I am reminded of the hearing which we had on H.J. Res. 438 giving rise to your current study and of the testimony given by Mr. Funston, president of the New York Stock Exchange to the effect that the insider trading reports should be filed within 10 days of the transaction rather than within 10 days of the following month, and that he urged the committee to put some "teeth into the law."

In addition, I think that those hearings brought up the problem of the persons who were covered by section 16(a). I do not recall the exact name of the case but remember that some partner of Lehman Corp. was involved, and while the Supreme Court apparently decided that he did not use his inside information within the ambit of the statute, nevertheless there was a loophole here where congressional action might be required.

I am undertaking this occasion to write you at some length for I feel that these appropriately may be matters which you may wish to take up at the time of your testimony on your proposed securities legislation inasmuch as I think the entire subject of insider interests is very clearly one which it was the subcommittee's intention to have covered in your study and ensuing recommendations.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 1, 1963.

Hon. HARLEY O. STAGGERS,
House of Representatives,
Washington, D.C.

DEAR MR. STAGGERS: This is in answer to your letter of July 2, 1963, which referred to my earlier letter and a memorandum from the Division of Corporation Finance of the Commission on the filing of reports of transactions in the common stock of Transportation Corp. of America by O. Roy Chalk.

I regret that the staff memorandum was unclear on the subject of reporting under section 16(a) of the Securities Exchange Act of 1934 (Exchange Act). By stating in that memorandum that 50,000 persons are subject to such reporting requirements and more than 40,000 reports are filed each year, it was not intended to imply that approximately 10,000 reports are not being filed on time. Such reports are required to be filed by persons subject to section 16(a) only when they have had transactions in the securities referred to in that section. Thus, the number of reports filed each year may vary considerably from the number of persons subject to the reporting requirements.

In a majority of cases, the Commission is able to check on an annual basis whether or not reports required by section 16(a) have been filed. Proxy soliciting material filed by companies pursuant to section 14 of the Exchange Act must state the ownership of securities by all persons who own more than 10 percent of the outstanding voting securities of the company and, if directors are to be elected, the ownership by each director of each class of equity securities of the company or any of its parents or subsidiaries. In this manner, an annual check is made on the security holdings for such persons through the proxy soliciting material which is filed by approximately 85 percent of the companies subject to section 14. In some cases, the requirement for filing a section 16(a) report is called to the attention of the Commission by the examination of corollary filings. However, in all cases the responsibility for filing such reports is on the person subject to section 16(a). If the proposed legislation which has been recommended by the Commission is enacted, all companies subject to the reporting

requirements of section 13 of the Exchange Act must either solicit proxies under section 14 of that act or furnish comparable information to its security holders and to the Commission. Under such legislation our annual check will be extended to all companies whose securities are subject to section 16. When there is a failure to file a section 16(a) report, administrative steps are taken which almost always produce the required reports. The Commission can, if necessary, resort to criminal prosecution or a mandatory injunction.

Although no specific penalty is provided in the statute for the late filing of reports pursuant to section 16(a) of the Exchange Act, the Commission does have the authority to recommend the initiation of criminal proceedings and bring injunctive actions to enforce compliance. While these sanctions have rarely been used, the late filing of section 16(a) reports does not affect the problem you raise in connection with 16(b), and the 2-year cutoff period for recapture of profits under that section. It is the position of the Commission, which has been followed by the courts, e.g., *Grossman* v. *Young*, 22 F. Supp. 315 (S.D. N.Y. 1947), that the 2-year period does not begin to run until the section 16(a) report is filed with the Commission. In view of this protection regardless of the lateness of the filing of section 16(a) reports and the fact that sanctions are available for deliberate noncompliance, while the courts would be reluctant to impose penalties for purely inadvertent delay, the Commission feels that no further penalties need be recommended for failure to file such required reports on time.

Consideration has been given to the suggestion of Mr. Keith Funston during the hearings on H.J. Res. 438 for requiring insider trading reports within 10 days of the transaction rather than within 10 days after the end of the month during which the transaction occurred. It should be noted, however, that the adoption of this suggestion would increase the number of reports that are filed because a person subject to section 16(a) could not accumulate his transactions during a particular month for inclusion in his report. This suggestion should be considered in any general legislative review of section 16, but we doubt whether it is of sufficient importance in and of itself to warrant undertaking such review, or submission of a legislative proposal directed to this particular matter.

As to the failure of a company to file with the Commission the annual reports required by sections 13 and 15(d) of the Exchange Act, the Commission has a positive and complete check which is continuously followed. When a failure to file occurs, steps are taken which generally effect compliance. In the event of continued noncompliance, enforcement proceedings are considered, and where warranted they are brought. In this connection it should be noted that the Exchange Act contains civil penalties in addition to criminal penalties for willful violations. Section 32(b) provides that in lieu of any criminal penalty for failure to comply with an undertaking to file annual reports, the issuer shall forfeit to the United States $100 for every day the failure to comply continues. The Commission can also bring a mandamus action to compel any issuer to comply with the Exchange Act to file its annual reports.

The problem raised in the case of *Blau* v. *Lehman*, 368 U.S. 403 (1962), to which you refer in the next to the last paragraph of your letter, has been considered by the Commission. In that connection it is significant that the Supreme Court indicated that section 16(b) liability for the entire firm could arise if the partner-director had been "deputized" to represent the firm on the board. Since it would seem that such a finding might well be possible in a good many situations, the exact impact of the decision is difficult to determine. Therefore, we do not believe that the decision in *Blau* v. *Lehman* creates such a "loophole" as to require immediate legislative action.

Should further information be desired, we shall be glad to furnish it.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION—*Washington D.C. 20549*

COMMISSIONERS: *William L. Cary*, CHAIRMAN
Byron D. Woodside
J. Allen Frear, Jr.
Manuel F. Cohen
Jack M. Whitney II
Orval L. DuBois, SECRETARY

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Explanatory Notes

Information contained in this summary has been taken directly from reports filed with the Commission. Such information is necessarily condensed or abbreviated. In the interest of simplification and economy, this summary omits reported data reflecting stock splits, stock dividends, rights, gifts, initial holdings (reported on Forms 5, 6, U-17-1, and N-30F-1), and unchanged holdings of any additional class of security (e. g., Preferred Stock) than that traded (e. g., Common Stock). Likewise it omits reports covering less than 100 shares purchased and sold combined during the month with respect to the class of security traded, and it discloses the aggregate number of shares purchased, and separately the aggregate number of shares sold, during the month with respect to each class of security traded by each reporting person, rather than the exact date of each transaction and the number of shares involved in each such transaction. The full reports may be inspected at the Commission or at the exchanges where they are filed, and photocopies thereof may also be obtained from the Commission at a nominal cost.

Publication of this information is in no sense a representation that the data as filed are correct, complete, or genuine. Responsibility for accurate reports rests with the reporting persons and not with the Commission or with any exchange.

On the following pages, the name of the issuer is followed by an abbreviated description of the security in which transactions are reported. Indented thereunder appears the name of the person reporting and his relationship to the issuer. If he has any indirect interest in the securities reported, as through holding companies, partnerships, trusts, etc., this is shown following his personal or direct interest and is indented as indicated in the column headings. Symbols are used in a column to indicate the character of the transaction, if otherwise than a purchase or sale, and the nature of ownership, if otherwise than direct (see Guide to Symbols below). "Amended Report" indicates an amendment of an original report which has been previously published.

Guide to Symbols

REFERENCE TO THESE SYMBOLS IS ESSENTIAL FOR A FULL AND ACCURATE INTERPRETATION OF THE DATA REPORTED

RELATIONSHIP (appearing after the name of the reporter)

"O" - OFFICER
"D" - DIRECTOR or person performing similar functions.
"B" - Beneficial owner of more than 10 percent of any registered equity security of the issuer in the case of reports under Section 16 (a) of the Securities Exchange Act of 1934 or of any class of outstanding securities (other than short-term paper) of the issuer in the case of reports under Section 30 (f) of the Investment Company Act of 1940.
"V" - VOTING TRUSTEE
"T" - TRUSTEE
"M" - MEMBER OF COMMITTEE or MEMBER OF ADVISORY BOARD
"I" - INVESTMENT ADVISER
"A" - AFFILIATED PERSON OF INVESTMENT ADVISER

NATURE OF OWNERSHIP

No Symbol - Securities are beneficially owned directly.
"1" - Securities are directly held, but person making the report disclaims any admission that he is the beneficial owner of the securities.
"2" - Securities are beneficially owned indirectly through a holding company, partnership, trust, or other intermediary; figures reported represent the TOTAL transactions and holdings of the intermediary.
"3" - Held the same as in "2" except that person making the report disclaims any admission that he is the beneficial owner of the securities.
"4" - Securities are beneficially owned indirectly through a holding company or other intermediary; figures reported represent the PROPORTIONATE interest of the person making the report.
"5" - Held the same as in "4", except that person making the report disclaims any admission that he is the beneficial owner of the securities.

CHARACTER OF TRANSACTION

No Symbol - PURCHASE or SALE
"B" - BEQUEST or INHERITANCE
"C" - COMPENSATION
"D" - DISTRIBUTION
"E" - EXCHANGE or CONVERSION
"F" - EXERCISE of RIGHTS, etc.
"G" - GIFT
"R" - REDEEMED (called, matured, retired)
"S" - STOCK DIVIDEND
"T" - TRANSFERRED or ACCRUED
"Z" - STOCK SPLIT
"X" - EXERCISE OF OPTION

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IMPORTANT – See Guide to Symbols on inside front cover

ISSUER / SECURITY / REPORTING PERSON / INDIRECT ACCOUNT		MONTH	Transaction and Ownership Symbol	AGGREGATE TRANSACTIONS: Bought Or Otherwise Acquired	AGGREGATE TRANSACTIONS: Sold Or Otherwise Disposed Of	Month-End Holdings Of Security Traded
TRANSPORTATION CORP OF AMERICA						
Class A						
O Roy Chalk	OD	7-19-62	S	2918		
		7-27-62	E	15878		
		8-7-62	*		15878	
		12-19-62	E	12776		
		12-19-62	G		2400	
		12-31-62	E	9000		
		12-31-62	G		9000	
		1-28-63	S	3316		113894
D C Transit System		Oct 1960	2	100		
		Dec 1960	2	700		
		Jun 1961	2	600		
		Jul 1961	2	5300		
		Aug 1961	2	1000		
		Sep 1961	2	600		
		Jan 1962	2	2500		
		Jan 1962	S 2	249		
		Feb 1962	2	1500		
		May 1962	2	13300		
		Jun 1962	2	2000		
		Jul 1962	2	2000		
		Jul 1962	S 2	816		
		Aug 1962	2	1500		
		Sep 1962	2	2500		
		Nov 1962	2	500		
		Dec 1962	2	31700		
		Jan 1963	2	500		
		Jan 1963	S 2	1930		69295
Fifth Ave Estates		May 1962	2	200		
		Jun 1962	2	100		
		Jul 1962	S 2	9		
		Jan 1963	S 2	9		318
Foundation		Dec 1961	2	5375		
		Jan 1962	2	676		
		May 1962	2	2200		
		Jul 1962	S 2	247		
		Dec 1962	2	9000		
		Dec 1962	G 2		9750	
		Jan 1963	S 2	522		
		Jan 1963	G 2		291	7979
T C A of America		Dec 1961	2	219		
		Jan 1962	S 2	6		
		Jul 1962	S 2	6		
		Jan 1963	S 2	6		237

IMPORTANT – See Guide to Symbols on inside front cover

ISSUER SECURITY REPORTING PERSON INDIRECT ACCOUNT	MONTH	Transaction and Ownership Symbol	AGGREGATE TRANSACTIONS Bought Or Otherwise Acquired	AGGREGATE TRANSACTIONS Sold Or Otherwise Disposed Of	Month-End Holdings Of Security Traded
TRANSPORTATION CORP OF AMERICA (Continued)					
O Roy Chalk Realty and Construction	Dec 1961	2	1349		
	Jan 1962	S 2	40		
	Jul 1962	S 2	41		
	Jan 1963	S 2	41		1471
Aviation Capital Corp	Dec 1961	2	50		
	Jan 1962	S 2	1		
	Jul 1962	S 2	1		
	Jan 1963	S 2	1		53
Metal Assoc Inc	Dec 1961	2	50		
	Jan 1962	S 2	1		
	Jul 1962	S 2	1		
*Exchanged for works of art - to be held under 2 year letter of investment	Jan 1963	S 2	1		53
Class B					
O Roy Chalk OD	7-19-62	S	20128		
	7-27-62	E		15878	
	12-19-62	E		12776	
	12-31-62	E		9000	
	1-28-63	S	19602		673021
6-1/2% Sub Conv Debs					
O Roy Chalk OD	12-3-61		$1000000		$1000000
D C Transit System	Dec 1961	2	$16600		
	May 1962	2	$11000		
	Jun 1962	2	$39000		
	Jul 1962	2	$18000		
	Aug 1962	2	$1000		
	Oct 1962	2	$53000		
	Nov 1962	2	$1000		
	Dec 1962	2	$28000		
	Jan 1963	2	$2000		$169600
Fifth Ave Estates	Dec 1961	2	$150000		
	May 1962	2	$5000		
	Jun 1962	2	$23000		$178000
Foundation	Dec 1961	2	$40000		
	May 1962	2	$11000		$51000
T C A of America	Jun 1962	2	$14000		$14000
2nd Ser Cl A Warrants					
O Roy Chalk OD	Dec 1961		30000		30000
D C Transit System	Dec 1961	2	498		498
Fifth Ave Estates	Dec 1961	2	4500		4500
Foundation	Dec 1961	2	1200		1200

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., August 8, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR MR. CARY: Thank you for your letter of August 2 commenting at some length upon mine of a month earlier relating to section 16.

As I suggested in my letter to you, the question of insider trading and of the recapture of insider profits, and of the responsibility for filing reports and penalties for failure to do so, seemed to me appropriate subjects for full discussion at the time we are enabled to conduct hearings on the recommendations emanating from your special study of the past 2 years.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

Mr. HARRIS. I believe in the memorandum that you referred to in connection with it you stated that there is no penalty in the statute for late filings of section 16(a) reports.

Mr. CARY. That is correct, sir. The question has come up, I take it, as to whether or not some penalty should be prescribed. That involves, again, the question of whether or not we want to open up that section for general discussion and for general amendment.

At this time, I think we would not. We thought we would leave it as it is.

Mr. HARRIS. Are you dropping it?

Mr. CARY. No, sir, we are not. We are going to discuss it further. But if this suggestion were made, there would be similar suggestions, may I say, to cut down the impact of this section which we think generally is a very excellent prophylactic statute against the use of insider information.

Mr. COHEN. May I merely add to that, Mr. Chairman, that most people file on time. In those situations where there has been a failure to file, the Commission does have power to go to court to obtain a mandatory order compelling the filing, and we have utilized that power when the occasion so demanded it.

Finally, of course, the failure to file is a criminal offense.

Mr. HARRIS. Mr. Cohen, I would like to remind you that in our legislative oversight investigation in 1959 and 1960 we got into some of this field, and there we discovered about the annual reports filing with the Commission, and we found that some of them were several years late, and some never were filed.

Mr. COHEN. Yes, sir. I was sitting in the audience during those hearings.

Mr. HARRIS. I do not have to remind you any further, then, as to what I have in mind. But you do have in mind studying this matter further and giving consideration to tightening up, so to speak?

Mr. CARY. We shall do so; yes, sir.

Mr. STAGGERS. Because of the late hour we will recess until 1:30, and contingent upon receiving permission to sit this afternoon we will reconvene at 1:30. Please be kind enough to return at that hour.

(Whereupon, at 12:07 p.m., the subcommittee recessed, to reconvene at 1:30 p.m., the same day.)

AFTERNOON SESSION

Mr. STAGGERS. The subcommittee will please be in order.

STATEMENT OF WILLIAM L. CARY, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION—Resumed

Mr. STAGGERS. When we recessed at noon, Mr. Harris was questioning the Chairman of the SEC. Mr. Harris, will you continue?

Mr. CARY. Mr. Chairman, before Chairman Harris begins his questioning, I would like to make a few remarks in response to some remarks that he made earlier in his questioning.

It is in connection with the work and cooperative efforts between the committee and the Commission during the period of this study and the bill. It was obvious that we needed an opportunity, as I said in the original statement, to back away and look at the situation in the securities industry. I think this committee was the first to recognize that fact.

We instinctively felt the need for a study; but it was the initiative of this committee that focused our attention on this need and gave us the opportunity to carry a study out. We welcomed the committee's action and I think it was certainly the only way in which we could move away from our day-to-day problems and get to the consideration of the industry as a whole.

All of this was provided by the original bill, the joint resolution, which gave rise to the Study and for which we are intensely grateful.

Since that time, I must say that I have worked very closely with Chairman Harris; Mr. Staggers, chairman of the subcommittee; and the staff, in every phase of it. It well remember the time we reported the fact that we could not get the Study completed by January 1, and the cooperation we received in having it extended to April 3, a deadline we did not fully meet, I might add.

We have also had the opportunity, through this committee, to report periodically and publicly, on the report as it came out. We have had encouragement in getting out the bill which is before you at the present time. I well remember discussions with Mr. Harris at one point in which he was the one who suggested that our proposals be incorporated in one single bill as distinguished from several.

We have been working in the same way in the last few months since the report has been completed. I know this committee has been interested in our progress. It wanted to await the publication of the total report. It was not available, in fact, in printed form until most recently.

As a consequence, I think we now have the basis not only for the bill, itself, but also for developing the rules on which we are working vigorously at this time.

I do want to say that we wish to express our genuine appreciation for the support we have received consistently throughout—in getting the Study going, having the authority for it, making the Study, reporting upon it and now I realize that a major phase of it is the implementation.

I know we have been receiving that support and I am sure we will receive it continuously from here on.

Mr. HARRIS. Thank you, Mr. Chairman. Of course, there was the matter of $1 million that was needed, too.

Mr. CARY. That is correct, sir, I did not mention that.

Mr. HARRIS. You are familiar with the court decision in the case of *Blaw* v. *Lehman*, in which the court decided that recourse to closing the loophole in section 16(b) should be handled through congressional action and not by the courts?

That is the case dealing with situations arising where the partner of a firm was on the board of directors of a company in whose stock the firm had made profits.

I don't believe there is legislation proposed in that direction; is there?

Mr. CARY. There is no legislation on that point, Chairman Harris. We gave it some consideration; as you say, we had some indication from the Supreme Court that it should be handled legislatively. But that ties in with the discussion we had this morning of opening up the question of amendments to section 16 of the Securities Exchange Act.

If we opened it up to reverse *Blau* v. *Lehman*, there would have been many other points which I think would have been brought up. I think we would have had a long and continuous discussion in arriving at any agreement. For that reason we did not go ahead.

Mr. HARRIS. In other words, it would be fair to say that you are centering your efforts toward increasing the coverage of the additional firms, instead of closing certain loopholes that for some years have developed?

Mr. CARY. That is correct, sir. We would like to make the same statute applicable to a larger number of companies.

Mr. HARRIS. With reference to section 3(a) of the bill, you propose certain material contracts to be filed with the Commission.

Mr. CARY. Yes, sir.

Mr. HARRIS. What is your interpretation of the word "material"? What do you mean by that? Is it material in the term of amounts or in terms of with whom the contract has been made, such as with officers or directors of the corporation, or both, or is it something else?

Mr. CARY. I think I would like to ask Mr. Cohen to speak to that point.

Mr. COHEN. The 1934 act does not presently relate to disclosure of material contracts, but the Commission has had considerable experience with that term under the 1933 act and in our forms we have rather elaborate rules designed to assist those subject to the filing requirements to understand what is required and what is not required.

As a generalization, we have in mind a contract, knowledge of which, or knowledge of the terms of which, is necessary to a proper evaluation of the security offered, that is, the nature of the business of the issuer and its continued operations.

Mr. HARRIS. But, Commissioner, would this require disclosure of such contracts as those entered into, as an example, between, say, Chrysler, a private corporation and firms in which officers had an interest?

Mr. COHEN. Contracts of that kind are required to be disclosed under both the 1933 act and the 1934 act. Those are contracts in which officers, directors, and other principal security holders have an interest, directly or indirectly. That type of disclosure is presently required in our reporting forms and in our proxy rules.

Mr. HARRIS. What about such contracts by the Union Oil Co. for the leasing of tank ships in which its officers and directors had an interest?

Mr. COHEN. That particular transaction came to our attention in connection with the processing or a registration statement under the 1933 act, and the registration statement, the prospectus therein, contained a very full discussion of those transactions.

Mr. HARRIS. Earlier we had a discussion relative to preemption. I believe you answered questions of other members of the committee.

Mr. Chairman, you have referred to the fact that section 28(a) still would remain, and that it should be perfectly clear that the repeal of this exemption interferes in no way with States' regulation of broker-dealers, because section 28(a) of the Exchange Act explicitly reserves jurisdiction to the States in those areas.

What bothers me is that the section says—

nothing in this title shall affect the jurisdiction of the Securities Commission of the State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.

I just can't understand how those two statements are at all compatible.

Mr. CARY. Mr. Chairman, I think it is a question of concurrent jurisdiction. If we received jurisdiction under this bill with respect to intrastate brokers, it would not preempt the jurisdiction of a State securities commissioner. Therefore, we would have concurrent jurisdiction with him in applying our requirements to brokers.

Mr. HARRIS. You do not feel that complete jurisdiction over the activities of a broker-dealer would not, in fact, override any which the State commissions may have?

Mr. CARY. I don't believe so. In a case that came up just in the last month, the State Securities Commission of the State of Washington had already commenced the investigation and was doing a thorough job. We, therefore, saw no need for our taking action.

So as a consequence we were not preempting any action which he took. In fact, we ceded it in that particular case. It is the same way, I think, here that we could act and we could act at the same time.

Mr. HARRIS. But do you have the power to do that?

Mr. CARY. Do we have the power?

Mr. HARRIS. Yes. The answer is obviously "Yes," you do have the power.

Mr. CARY. We would have the power, yes, sir; in this area. It does not mean we would have the exclusive power. That is the only point I was making, Mr. Chairman.

Mr. HARRIS. The question raised in my mind is that it seems to me that maybe some of the complaints of the State commissions might be justified in view of the fact that you could completely preempt them in the field. But you say you could not, and you read your statement which I referred to a moment ago.

Mr. CARY. Yes, sir. Maybe I will ask Mr. Cohen to speak further to this, as well.

Mr. COHEN. Chairman Harris, everyone of the statutes administered by the Commission contains a provision comparable to section 28(a). In fact, this is a cardinal feature of the statute as suggested by this committee and as enacted by the Congress.

A great deal of the business which the Commission now does throughout the land is business over which many of the blue sky commissions have jurisdiction over, also, many of them, and exercise that jurisdiction every day.

What the Commission is doing here is merely seeking some additional jurisdiction but not in any way derogating from the State jurisdiction or in any way derogating from the rights and powers of the State administrators.

As a matter of fact, the Commission, as the chairman has pointed out, has endeavored through the years to cooperate with the State administrators and suggested on occasion matters that he might handle as a matter of local interest, even though they fall within our jurisdiction.

Mr. HARRIS. Section 28(a) is applicable, as you so well indicated presently, and to which you referred with reference to its effect on existing law. But I wish to remind you that 15(a) provides no broker or dealer "other than one whose business is exclusively intrastate."

That is in present law today, but you are repealing that provision.

Mr. CARY. That is correct, sir. It is really not a provision but it is a repeal of a provision that would give us this jurisdiction over intrastate broker-dealers.

Mr. HARRIS. Your statement, then, cannot be accepted as in full effect and force.

Mr. CARY. So far as I can see, assuming this bill were passed in its present form, which would give us this jurisdiction, sir, it would not mean that the State "blue sky" commissioner would not also have jurisdiction. That would be the point that we are making.

I recognize you are absolutely correct that the basis on which we now ask for jurisdiction over intrastate brokers is through the repeal of that parenthetical statement in 15(a).

Mr. HARRIS. Then your statement cannot be accepted in its entirety, about the jurisdiction.

Mr. CAREY. I would like Mr. Loomis to make a comment on that.

Mr. LOOMIS. Under the present law, those broker-dealers who register with us, those whose business is not exclusively intrastate, are still subject to whatever requirements the State commissioners may impose upon them. For example, certain States, New York recently, impose a minimum capital requirement.

They have to comply with that, as well as with our requirements. They are required, even though they are registered with us, to obtain a license from the securities commissioner of the State in which they are located, and he can impose such conditions as he sees fit upon that license.

Frequently, he requires them to take an examination. Frequently, he passes upon their character and competence. None of this would be changed by this bill. As to the exclusively intrastate broker-dealers who under this bill will be in the same status as the others who are now registered with us, the State commissioners will continue to exercise the jurisdiction which they now exercise over those who are registered with us.

Mr. HARRIS. Mr. Loomis, I certainly do not mean anything personal at all. People can differ in their opinions. I simply and respectfully say that I cannot agree with you, and I don't think anyone

should labor under any illusions around here, because the powers that are given under this language, in my judgment, would completely nullify any provision of any State law that would be contrary to this language and to your rules and regulations.

If I am wrong about that, I would like to be corrected. If I can read English at all, that is the point.

Mr. LOOMIS. All I can say to that, sir, is that over the past 30 years I have not known of any instance in which we have had to take the position that——

Mr. HARRIS. I am not talking about that, Mr. Loomis. I am talking about the power and authority this gives you.

Mr. LOOMIS. All I am attempting to say, sir, is that it is most unlikely that there would be any such conflict. I have never encountered one.

Mr. HARRIS. I am not talking about that. I am talking about what we are doing here in legislation. I think we should limit it to what we are doing, so we will know what we are doing and not what you will do in the administration of this. We are talking about the authority and the power which you are asking and which it is proposed we give you.

I think everybody ought to understand precisely what it does. I don't believe we should let statements get by in the record which may very well mislead people. I know you don't intend that, but I intend to do what I can to make the record straight on it.

I don't think I am kidding myself at all that if you have a rule, you have the authority under this language to see that it is carried out. And if any provision of any State, regardless of where it is, is contrary to that rule, then you are going to preempt it.

That is the way I see it from the language. Anyway, I think it has been made very clear for the record, regardless of who is right.

At this point in the record, I think it may be well to include some correspondence which you have had with our staff regarding this subject of preemption.

Mr. STAGGERS. Without objection, it is so ordered.

(The correspondence referred to follows:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., July 26, 1963.

DR. ANDREW STEVENSON,
Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR ANDY: This will confirm my telephone conversation with you today concerning the proposal in our legislation dispensing with proof of the use of the mails or interstate commerce facilities in the case of particular transactions by registered brokers and dealers. After your visit with Barney Woodside and me a week ago, I appreciated for the first time that this might be a matter of some concern to you and to the committee. Under these circumstances, I suggest that in my opening statement before Chairman Harris' committee that we should emphasize the fact that the Commission's jurisdiction is entirely dependent on the use by broker-dealers of the facilities of interstate commerce or of the mails. This would nail the point down so clearly that any doubt raised with respect to the basis of jurisdiction would be foreclosed. I am enclosing a draft of a statement which we have prepared with respect to this point, and wonder if you would take a look at it and let us know when you have time to discuss it with us.

I did mention to you over the telephone that in the Senate report which just came out, on page 46, under the heading "Proof of Use of the Mails," there has been inserted a final sentence as follows:

"The application of the act to these transactions would, of course, continue to depend ultimately on the interstate commerce clause and the use of the mails."

I would appreciate hearing from you whenever it is convenient.

With all best wishes.

Faithfully yours,

WILLIAM L. CARY, *Chairman.*

DRAFT REVISION OF STATEMENT WITH RESPECT TO SECTION 6(b) (JURISDICTIONAL FACILITIES) OF THE BILL

The Commission's jurisdiction over brokers and dealers is, of course, entirely dependent on their use of the facilities of interstate or foreign commerce or of the mails. Such jurisdiction, once it attaches, should necessarily extend to all the activities of such brokers and dealers. It is therefore somewhat inconsistent, unnecessary, and in our view undesirable, that the Commission's jurisdiction over particular transactions of a registered broker-dealer should depend upon the use of such facilities in the particular transaction, assuming the general use of the facilities of interstate commerce or of the mails in the conduct of business. Consequently, section 6(b) of the bill dispenses with proof of the use of these facilities in connection with particular prohibited acts or practices, by registered broker-dealers. This would avoid situations where a particular prohibited act, ordinarily a fraud on an individual customer, goes unpunished because jurisdictional facilities were not used in that particular transaction. It would also avoid the necessity of spending a substantial amount of time and effort in collecting evidences of the use of interstate facilities or the mail, such as envelopes or telephone toll tickets, in connection with cases against registered broker-dealers. This essentially useless effort is a waste of the taxpayers' money and its elimination would free the Commission's staff for more productive work.

There is precedent for this in existing law, in that sections 7 and 8 of the Securities Exchange Act prohibit certain acts in connection with the extension of credit or the handling of customers' securities by certain broker-dealers irrespective of whether or not jurisdictional facilities are used in connection with such acts. In addition, the Investment Company Act of 1940 requires investment companies that utilize the mails or facilities of interstate or foreign commerce to register with the Commission, and thereafter all of the detailed requirements and prohibitions contained in that act are applicable to the registered investment company and its affiliated persons whether or not the mails or interstate facilities are used in the transactions referred to.

In summary, this amendment recognizes and is in no way inconsistent with the basic concept that Federal securities regulation is bottomed on interstate commerce and the mails. All the amendment does is to facilitate Commission enforcement and protection of the public through reliance upon the general use of the facilities of interstate or foreign commerce or of the mails by registered broker-dealers rather than insisting upon a particular use of these facilities in particular unlawful transactions.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., September 11, 1963.

Hon. WILLIAM L. CARY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR BILL: There has not been much opportunity before this to give thought to your letter of July 26 and enclosure of memorandum from Phil Loomis respecting section 6(b) of H.R. 6789.

As you know, I was troubled some years ago when Phil made the proposal in the legislation then suggested that the law dispense with proof of the use of the facilities of interstate commerce or the mails in connection with particular prohibited acts or practices by registered broker-dealers.

I well recognize the desire of enforcement officers to make such enforcement as easy as possible, and suppose all of us dislike to see some crook getting away with something because of the difficulty of proving that he did it. On the other hand, I am still troubled as to whether or not with the enactment of the proposed section 6(b) you would move in to all transactions of the broker-dealer, whether of interstate or intrastate character. I think it likely that the Federal Government could preempt the field constitutionally but I have not yet come to the conclusion that it is desirable that the Federal Government should do so.

My concern over what appears to be an implied "preemption" in section 6(b) is enhanced by a recent Illinois court decision reported in Commerce Clearinghouse where the judge went so far as to say that a stock transaction within the State of Illinois, by a resident of Illinois, in an Illinois corporation, without the use of the mails, was still subject to the Federal securities laws, and he went on to say that while he knew his interpretation probably was far out from what the laws now state, nevertheless, he thought in the future he would be proved right.

Sincerely yours,

ANDREW STEVENSON.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., September 23, 1963.

HON. ANDREW STEVENSON,
Committee on Interstate and Foreign Commerce,
Longworth House Office Building, Washington, D.C.

DEAR ANDY: Thank you for your letter of September 11, 1963, with respect to section 6(b) of H.R. 6789.

I am attaching a memorandum of law prepared by Mr. Morgan Shipman of our staff with respect to this matter which I think shows that this section is an exercise of the Federal power over the mails and instrumentalities of interstate commerce and that it is constitutional. I gather from your letter that you are not too much concerned about the powers of Congress but that you are troubled by the policy question. At the outset I want to emphasize that the purpose of this change is not to expand our jurisdiction over registered broker-dealers, which is already comprehensive, but rather, to relieve our enforcement staff from the essentially useless task of sending for and collecting envelopes or other evidences of use of the mails or interstate facilities in connection with particular transactions, thus enabling us to use our resources more productively and eliminating unnecessary expense to the taxpayers.

As I am sure you realize, there is no technical "preemption" since the States remain free to register and regulate all broker-dealers, as is made clear by section 28(a) of the act. I assume therefore that your real concern is with our getting into the field of purely intrastate transactions at all.

It seems to me that section 6(b) will not get us much further into the regulation of intrastate transactions of registered broker-dealers than we already are. Various general regulations of the conduct of the business, such as the bookkeeping rules, the margin rules and, as a practical matter, the capital rules apply whether particular transactions are interstate or intrastate, and whether or not the mails or interstate instrumentalities are used in them. Members of exchanges are subject to certain provisions merely because of their status as such, and any transaction on an exchange is subject to our jurisdiction, even if all of the parties reside in the same State, since a national securities exchange is itself a facility of interstate commerce, as Professor Loss points out at page 1521 of his book. More significantly, any use of the mails invokes our jurisdiction even if the addressee lives across the street. Broker-dealers use the mails in most of their transactions, local or otherwise, if only to send out confirmations, and the great bulk of their activities thus comes within our jurisdiction.

I think it also significant in this connection that the use of the mails or interstate facilities does not have to be an essential or even an important part of a transaction in order to bring it under our jurisdiction. As you probably know, the courts have interpreted this aspect of the matter broadly. Even if a defendant in an SEC case did not use the mails himself at all, it is sufficient if he caused somebody else to use them or might reasonably have foreseen that their use would occur. It has been held that it is enough if the mails are used to transmit the victim's check from one bank to another bank for collection. In the recent

case of *United States* v. *Cashin*, 281 F. 2d 669, 673 (C.A. 2, 1960) Chief Judge Lumbard expressed the principle governing this matter as follows:

"* * * The gist of the crimes charged in the indictment, as in most Securities Act cases, is the fraudulent scheme employed in the sale of securities. See *United States* v. *Robertson*, D.C.S.D.N.Y. 1959, 181 F. Supp. 158; *United States* v. *Monjar*, *supra*. The purpose of the requirement that there be a use of the mails or other facilities of commerce is solely to create a basis for Federal jurisdiction. *Creswell-Keith, Inc.* v. *Willingham*, 8 Cir., 1959, 264 F. 2d 76; *Schillner* v. *H. Vaughn Clarke & Co.*, 2 Cir., 1943, 134 F. 2d 875; *United States* v. *Robertson*, *supra*. The use of the mails need not be central to the fraudulent scheme and may be entirely incidental to it. See, e.g., *Kopald-Quinn & Co.* v. *United States*, 5 Cir., 101 F. 2d 628, certiorari denied subnom. *Ricebaum* v. *United States*, 1939, 307 U.S. 628, 59 S.Ct. 835, 83 L.Ed. 1511. Indeed, in the very case before us the only alleged use of the mails was to confirm purchases already induced by the defendants' deceit. No claim is made that fraudulent matter was mailed or even that the mailings alleged were necessary to the execution of the unlawful scheme."

In the case in Illinois to which you refer, the court held that the telephone was a facility of interstate commerce even if the particular call was entirely within one State. At about the same time, a district court in Pennsylvania went the other way on that point. If either of these cases is appealed, we may get that question settled.

I, of course, agree with you that distinctions which are significant in separating matters of proper Federal concern from those which are purely local should not be overridden merely to make it easier to catch a crook. On the other hand, as the law has developed in this area, we are already deeply involved in the intrastate activities of registered broker-dealers. The search for some incidental use of the mails or of some interstate facility somewhere in an allegedly fraudulent transaction does not seem to reflect any meaningful distinctions of policy as to where our regulation of registered broker-dealers should leave off and, if unnecessary for constitutional reasons, seems a mere formality rather than a significant process for distinguishing between matter which are of Federal concern and those which are not. If this type of search does not serve a meaningful purpose as a matter of policy, then there appears to be justification for eliminating it even if only to make it easier, or in some cases possible, to catch crooks.

Incidentally, Phil Loomis tells me that the credit, if such it be, for originating this idea back in 1956 belongs to his predecessors, although he agrees with it and had something to do with reviving it.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

MEMORANDUM

Re basis of jurisdiction over acts of broker-dealers registered with the Commission.

Section 6(b) of the bill would amend section 15(b) of the act by adding thereto a new fourth paragraph in section 15(b)(1). This new paragraph would specify that in the case of any broker-dealer registered with the Commission, or any person acting on behalf of such a broker-dealer, any provision of the Securities Exchange Act of 1934 that prohibits any act, practice, or course of business if the mails or any means of interstate commerce are used in connection therewith shall also prohibit such act, practice or course of business without regard to use of interstate commerce facilities in connection therewith.

As is the case under existing law, a broker-dealer would not be required to register with the Commission unless he uses the mails or a means or instrumentality of interstate commerce in conducting his business. For this reason, the liabilities and regulation of broker-dealers registered with the Commission and of persons acting on behalf of such broker-dealers would continue to rest on the commerce clause and the use of the mails, for if such jurisdictional facilities are never used by a broker-dealer, he need not register with the Commission. Stated another way, a broker-dealer who chooses to conduct his entire business without use of the mails or a means of interstate commerce would avoid the application of the act to him and to all persons acting on his behalf. Thus, the commerce power and the power over the use of the mails would remain the powers which would require registration, and since registration would be the key act that would result in the application of the new fourth paragraph of

section 15(b)(1), that new paragraph would also clearly be based upon the commerce powers and the powers over the use of the mails. The source of the congressional power over the acts that bring a person within the scope of the statute is also the source of the power over all acts regulated by the statute, especially when the portions of the statute regulating specific acts contain no reference to, and no nexus with, any other source of congressional power.

Many provisions of the Securities Exchange Act of 1934 now proscribe certain acts even though the mails or a means of interstate commerce are not used in the specific acts in question. For example, section 16 imposes certain liabilities and responsibilities upon insiders of issuers with a security listed on a national securities exchange regardless of the use or nonuse of the mails or a means of interstate commerce in such transactions. Also, section 8 of the Securities Exchange Act of 1934 now prohibits broker-dealers who are members of a national securities exchange or who transact business through the medium of such a member from doing certain acts, regardless of whether the jurisdictional facilities are used in the particular proscribed acts. In both cases, the ultimate power rests upon a relationship with a national securities exchange, which is of course an instrumentality of interstate commerce and which is regulated under the commerce power and the power over the use of the mails.

The constitutionality of subsection (b) of section 16 (the profit-recovery portion of that section) has been litigated and has consistently been upheld by the courts. See, e.g., *Gratz* v. *Claughton* (187 F. 2d 46 (2d Cir. 1951), cert. denied, 341 U.S. 920), and *Smolowe* v. *Delendo* (136 F. 2d 231 (2d cir. 1943), cert. denied, 320 U.S. 751). In these cases the second circuit held that section 16(b) of the Exchange Act was a valid exercise by Congress of the commerce power, the reference to the commerce power being explicit in *Smolowe* and implicit in *Gratz*. No other source of congressional power was mentioned.

Also to be considered are provisions of the Securities Exchange Act such as section 17(a), which requires all broker-dealers who are members of exchanges or who are registered with the Commission to make, keep, and preserve such records as the Commission shall prescribe, without regard to whether the transactions recorded were effected in intrastate or interstate commerce or with or without the use of the mails or a means of interstate commerce.

The Investment Company Act of 1940 also contains the same pattern as the one proposed for broker-dealers registered with the Commission under the Securities Exchange Act of 1934. Investment companies using the mails or a means of interstate commerce are required to register with the Commission and once registered are prohibited from doing certain acts regardless of whether the jurisdictional facilities are used in doing a particular act.

A pattern somewhat similar to that proposed concerning broker-dealers is found in the Public Utility Holding Company Act of 1935. Section 4 of the Holding Company Act forbids the use of the mails or of the channels of interstate commerce to certain public utility holding companies unless they are registered with the Commission. Once registered, such companies are subject to the Commission's jurisdiction to simplify the structure of such holding companies and their subsidiaries, without further specific reference to use of the mails or a means of interstate commerce. This statutory pattern has several times been held constitutional. See *American Power & Light Co.* v. *SEC* (329 U.S. 90 (1946)); *North American Co.* v. *SEC* (327 U.S. 686 (1946)); and *Electric Bond & Share Co.* v. *SEC* (303 U.S. 419 (1938)). In these cases, the Supreme Court squarely held that the pattern of the Holding Company Act was a valid exercise by Congress of the commerce power and the power over the use of the mails. No other source of power was alluded to. These cases demonstrate that the commerce clause and the power over the use of the mails can validly be used in a two-stage regulatory pattern whereby (1) a business using the mails or a means of interstate commerce must register, and (2), once registration is accomplished, the business is subject to certain types of regulation without reference to the use of the jurisdictional facilities in particular transactions. These cases also demonstrate that in such a pattern, the commerce power and the power over the use of the mails remain the pertinent ones.

Mr. HARRIS. Now, Mr. Chairman, the Securities Exchange Act of 1934 is based to a substantial degree on the principle that both the exchanges and the over-the-counter associations should be substantially self-governing by certain rules for the protection of the public in the conduct of their operation.

Your staff study, chapter 12, I believe, concludes that regulation in the securities field should continue to be based upon this principle of self-regulation, and you are very strong for that, I suppose, from your statement today.

The study goes on to say, however, Government participation is necessary also to asure that action taken in the name of self-regulation fairly serves a valid public purpose and is not for a purpose inimical to antitrust or other public policy. Conversely, that bona fide self-regulatory action is not inhibited because of a risk of liability in absence of Commission review.

That is the statement of the study, itself. I would like to have your comment on whether or not the statutes today are adequate with regard to carrying out this self-regulation. I am referring to the self-regulation principle.

Mr. CARY. Mr. Chairman, we have been worrying through this problem and trying to arrive at a final judgment with respect to it. At this point, I would say that our belief is that our present powers are adequate in the sense that we are not coming to you now and asking for legislation giving us additional power.

The question, of course, comes up in one area via the case of Silver against the New York Stock Exchange. Although it is perhaps a narrow case in respect of its holding, it nevertheless raises the broad question, for example, of Commission review over self-regulatory institutions, specifically the exchanges.

In this matter, as I indicated earlier this morning, we have had substantial discussions with the New York Stock Exchange. We raised, first of all, the issue as to whether or not the applicability of the antitrust laws might inhibit the self-regulatory activities of the exchange. That was a question we addressed to the New York Stock Exchange. We had some fear of such a result, and, indeed, there was some indication originally that the exchange thought a diminution of their activities might occur.

We have now statements from the Exchange—and I am sure that the representatives will speak to this problem today—to the effect that they do not expect the antitrust laws to inhibit them with respect to their regulatory activities over registered representatives or firms.

In that context then the question comes up would they feel more free from antitrust problems, for example, if disciplinary actions of the Exchange were subject to review by this Commission. I suppose the answer is, in the light of the *Silver* case, they would probably feel more secure, though not perhaps totally secure from the antitrust laws.

But at the present time they have stated that, in their opinion, they do not wish to ask for Commission review in order to insulate themselves more fully from the antitrust laws. We have considered this question and we are not at this time prepared to ask the Congress that there should be such review power.

The above represents one area which was reported on and analyzed in chapter 12 of the Special Study.

In other areas we have had the question of what authority we should have not only vis-a-vis the New York Stock Exchange but also vis-a-vis the NASD. Some consideration was given to extending our powers. However, we have decided at this point that the powers we

presently have, primarily through the antifraud sections of the Exchange Act, give us very substantial controls in the area of the activities of the NASD. For that reason we have decided at this time, at least, not to proceed to ask for additional powers.

Mr. HARRIS. Thank you, sir. Would you advise the committee if your Special Study group gave attention or ascertained the adequacy of protection now afforded to investors in markets for Government securities, municipal bonds, and the like?

Mr. CARY. Mr. Chairman, that is an area we did not go into in the Special Study. It is a huge area, as you know. Municipal bonds are not traded to any extent on the New York Stock Exchange or other exchanges. Transactions with respect to them are not, supervised by the NASD.

We decided that we had to limit our inquiries at some point or another. This was one area which we decided we could not get into without spending a very substantial proportion of time upon it.

Since the very nature of the House joint resolution stemmed in part, I think, from the activity and turbulence of the market generally, and the points that were made yesterday, it seemed to us that a municipal bond examination was somewhat unrelated to these purposes. Therefore, as a matter of choice we decided not to undertake a study of municipal bonds.

Mr. HARRIS. You are familiar with the term "specialist functions"?

Mr. CARY. Yes, sir.

Mr. HARRIS. Your Special Study group did deal with this subject?

Mr. CARY. Yes, sir.

Mr. HARRIS. What is the Commission's position with regard to specialists at this time?

Mr. CARY. Mr. Chairman, I can give it in a general way and then I will ask Mr. Loomis to speak to it more fully.

First of all, may I say that when we got into this question we found it an exceedingly complex one, and we don't have any flat answer to the whole question.

Mr. HARRIS. Would it be fair to ask you if you believe that there is really a need for specialists?

Mr. CARY. Yes, sir; we feel that there is such a need. The Special Study has come up with a series of recommendations. In other words, there isn't any flat conclusion as to what improvement can be made, but a series of recommendations have been made in that area, and we are exploring them at the present time.

Mr. HARRIS. Then you probably will deal with it by rulemaking?

Mr. CARY. We shall; that is correct. And we presently, indeed, have had a number of discussions, primarily with the New York Stock Exchange, on that very subject already.

Mr. HARRIS. Likewise, a great deal of consideration or at least some attention was given to the role of floor trading.

Mr. CARY. Yes, sir.

Mr. HARRIS. And there were certain recommendations with reference to this subject. What is the Commission's thinking on this recommendation?

Mr. CARY. The Commission's general attitude? As you may recall, in the Special Study the recommendation was to the effect that floor trading should be abolished on the major exchanges. Our position

was that the Special Study presented a very good argument and made a very good brief for that abolition; therefore, it raised the question whether floor trading should continue on a public market.

However, we don't take this recommendation flatly on the basis of the study. We should have the other side's position. We have given the New York Stock Exchange and the American Stock Exchange an opportunity to reply. The former has engaged a special firm to make a study of this subject and we are awaiting their report. At that point we shall either act directly in the light of their brief and the arguments which they make, vis-a-vis the findings of the Special Study, or we shall have a public hearing on the subject.

Mr. HARRIS. When you were here with reference to the Resolution 438 that brought about this study, you described to the committee the increased referrals of criminal cases to the Department of Justice, the increased number of disciplinary actions by stock exchanges and by the NASD, the increasing investigations, and so forth and so on.

You referred to this earlier in the day. Are these types of manipulations as rampant today as they were in 1961 when you were telling us about them?

Mr. CARY. Mr. Chairman, our activities in this area are just as great. Of course, there is a certain amount of a timelag, as you well recognize. For example, a criminal case that is currently being referred may result from a transaction which took place back in 1958, let's say, or even an earlier year.

The answer to you is that statistically, and in fact, we are continuing at alltime highs in respect of injunctive actions which we bring, in respect of administrative proceedings which we bring, and in respect to criminal referrals. Indeed, I think right now our criminal referrals are really higher than they have ever been.

Mr. HARRIS. That is amazing to me at this time.

What is a thin market?

Mr. CARY. A thin market is a market in which there are relatively few buyers and sellers and, as a consequence, although there is a market price, it might be applicable only, to say, a maximum of 100 shares. Therefore, if it were found that you were offering 500 shares, the spread would immediately be much wider. In other words, you cannot be sure of selling your shares at a fixed price if there is a thin market and you have a large number of shares.

Mr. HARRIS. Did your Wharton School of Finance & Commerce raise some questions in this field?

Mr. CARY. No, sir; not that I know of. This would be primarily the mutual fund study, the Wharton School.

I will check that with Mr. Conwill, the director of our division of corporate regulation, but he doesn't indicate that there is anything on that point.

Mr. CONWILL. No, sir.

Mr. HARRIS. It is recognized that one of the great problems of maintaining a market in a given security is the number of shares of that security which may be outstanding and might enter such market. Do you agree to that?

Mr. CARY. Yes, sir; there may be this problem—and this is something that you might have reference to, Chairman Harris—in connection with mutual fund purchases of shares. There has been a very

substantial movement toward the purchase of shares which are listed on exchanges off the exchange—of buying them through broker-dealers who are not members of the exchange.

This trend has developed in recent years. I think it was mentioned in the Wharton School report and analyzed in the Special Study.

Mr. HARRIS. I had understood that in that report there was instance after instance of large proportions of issues held by investor companies, pension funds, bank trusts, fiduciary institutions, and groups of that kind.

Mr. CARY. That is correct; yes, sir.

Mr. HARRIS. In other words, as was pointed out in the report, that was the trend that was being accentuated quite a lot.

Mr. CARY. Of course, one of the great purchasers in the securities market today is these investment companies. Another important area of purchasing today, institutional, is through pension trusts and the like. You do find, as you have indicated, very substantial holdings of the leading securities in the portfolios of investment companies today.

Mr. HARRIS. Do you think the rules for the protection of investors in situations of this kind are adequate today?

Mr. CARY. In that field? That raises several questions. First, looking at it from the standpoint of the institutions, that is, the investment companies; and second, looking at it from the standpoint of the exchange.

From the standpoint of investment companies, they are frequently purchasing and selling off the exchange, even though they are exchange-listed securities. They do that in large part to reduce the commission which they have to pay. That is one of the reasons. And perhaps because they may, in some instances, get a better price.

Mr. HARRIS. Is there any protection where large blocks are disposed of by such an institution?

Mr. CARY. Mr. Conwill, would you speak to this?

Mr. CONWILL. I think I now understand Chairman Harris' reference to the thin market in the context of the Wharton School report.

As the chairman has indicated, investment companies, because they do, or many of them, hold large blocks, if you should have a thin market in the stock in which they hold a large block that they wanted to dispose of, that would accentuate the thin market problem; that is, their disposition of that block would have more of an impact upon the price fluctuation of that issue. That was observed by the Wharton School study.

As to the existing rules on the subject, I may be wrong on this, but I don't believe we have any that provides protection in that area.

Mr. CARY. Mr. Whitney might want to add to this.

Mr. WHITNEY. Chairman Harris, any distribution, whether by an institution, such as a mutual fund or anyone else, is subject to the anti-manipulative section of the Exchange Act and our rules and regulations thereunder. We have quite a few rules, and the stock exchanges themselves have rules relating to so-called secondary distributions, special offers that are effected on the floor of the exchange.

If the offering is effected on the exchange, it is under those rules. If it is off the exchange, it is under our rules, and I would say that generally our experience has been that those rules are adequate.

Mr. HARRIS. Following up on this, first I will ask you, don't you have a policy that you have adopted with reference to variable annuity plans?

Mr. CARY. Yes, sir. With respect to variable annuities, we have taken the position in the courts, Chairman Harris, that the offering of variable annuities is an offering of securities subject to the Securities Act, and also the Investment Company Act. We had one case which went the Supreme Court called *SEC* v. *Variable Life Insurance Company*.

Mr. Conwill argued a case in connection with the Prudential Life Insurance Co., in which their proposal for a variable annuity raised the same question. They were claiming it was a life insurance company and not, therefore, subject to the Securities Act or subject to the Investment Company Act, and we took the opposite position.

Mr. HARRIS. Is that the decision of the Commission on the case where other companies want to be treated likewise?

Mr. CARY. Mr. Chairman, on that, I will ask Mr. Conwill to speak to that. He argued the case.

Mr. CONWILL. Each company of which we are aware or which has approached us proposing to get into this business, we do assert the same policy; that to the extent that they are in this business, they are issuing securities subject to registration under the Securities Act, and they are operating investment companies subject to regulation under the Investment Company Act.

We give them all equal treatment, but I do want to emphasize that it is only the investment company operation that we regulate. We don't touch the insurance operations that they may have.

Mr. HARRIS. In other words, since you have made your initial step, your decision in this field, this business, whatever the policy decision you made would be applicable to all as they come along?

Mr. CONWILL. Yes, sir.

Mr. CARY. Absolutely. In fact, we are carrying that further, Mr. Chairman, in the field of banks. That is where the commingled problem comes up.

Mr. HARRIS. That is what I had in mind, with reference to collective trusts. I believe I suggested to you to be prepared to give us some information on this heretofore.

Mr. CARY. Yes, sir.

Mr. HARRIS. Of the newly created common trust funds, the collective trusts arising from changes in the law transferring jurisdiction over trust powers of national banks to the Federal Reserve Board, and to the Comptroller of the Currency, and arising from recently enacted legislation, I think has been referred to.

In view of the statutes, and the rules and regulations, and the court interpretations relating to similar types of securities issued by investment companies or mutual trusts, and by the insurance companies under these variable annuity plans, I wonder if it wouldn't be appropriate for you to indicate just how these common trust funds are operated under the securities law, if you would.

We gave you advance warning that this was going to be asked.

Mr. CARY. Yes, sir. I don't normally do this, but I even had a chart prepared, Mr. Chairman. That is the one that has been hiding. I don't think it is anything so important to have been hidden this way. I will ask somebody to let the chart down.

I am not sure it is an ideal way to show this to the committee.

It isn't really a very subtle chart. It is to demonstrate our attitude toward a whole set of common problems. I may have Mr. Conwill supplement my discussion, but I do want to start it off, if I may.

Basically, as you know, on the left-hand side, we point out who the sponsor-underwriter of a pool of securities—or mutual fund—is. The sponsor can be a private investment counsel, as Mr. Keith, coming from Massachusetts, can testify. A lot of investment companies started in Massachusetts, stemming out of investment counsel firms which had decided that small investors could not be taken care of privately by regular investment counsel activity. Therefore, they decided to pool the funds of these small accounts and become an adviser to that fund.

So you find the private investment counsel would be sponsoring the fund, and they would also probably act as adviser to it. Similarly, this has been done by broker-dealers who act as the sponsors or underwriters of mutual funds. The above are the traditional mutual funds or investment companies with which we have been working ever since the enactment of the Investment Company Act of 1940.

Now, we have two developments, both of which have taken place in the last few years. One is the insurance company sponsoring an investment company and offering variable annuities. In a variable annuity, the amount you receive depends on the fluctuating value of the pool of securities in which the variable annuitant has an interest. The insurance company is the investment adviser or would be the investment adviser with respect to that separate fund which would be wholly apart from the other assets of the insurance company.

At the same time we now have in the banking field a proposal that banks shall get into the mutual fund business; that they shall be the sponsor and underwriter of a separate fund, in effect; and they will be the investment adviser with respect to it. Their fee will be derived in substantial part from the advisory fee. There are other forms of fees that the banks might receive, or at least that are being received by, say, broker-dealers and others when they are sponsoring funds.

But basically investors are in the same position: whether it be a fund in which variable annuitants have an interest; or whether it be a commingled fund of a bank; or whether it be a mutual fund sponsored by a broker-dealer or investment adviser.

That is why we are being fully consistent in the position taken in the courts at the present time vis-a-vis the insurance companies and the position we are taking at the present time with regard to banks.

It is a change in the regulations of the Comptroller of the Currency which would now permit, for the first time, this kind of commingled fund to be merchandised by banking institutions.

I might ask Mr. Conwill, who has been working in this field so intimately, to supplement my discussion.

Mr. CONWILL. I can think of only one supplement to make, and that, really, for purposes of those who later read the record. That is in connection with the application of the Investment Company Act.

Both banks and insurance companies strongly assert that we have no jurisdiction under the Investment Company Act because they are exemptions from that act for both banks or insurance companies. We strongly assert that those exemptions are for insurance companies in

the context of their insurance functions and for banks in the context of their banking functions.

We feel very strongly that if an insurance company or a bank creates an investment company, that investment company should be regulated just like any other mutual fund even though it has been created by an exempt bank or insurance company.

Mr. KEITH. Mr. Chairman——

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. I think perhaps that impression you conveyed with reference to the insurance companies is not as universal as you indicate. I believe only a few of the insurance companies, relatively speaking, feel that the variable annuity should not come under the SEC for supervision. I think a large number of insurance companies feel that when the life insurance companies go into a speculative form of investment, it should come under the SEC.

I think perhaps some of those who are in the business have hoped to avoid this kind of regulation, but I think that the industry as a whole would not subscribe to the point of view of Prudential.

Mr. CONWILL. I think that is quite an appropriate observation, Mr. Keith. There are several insurance companies who have approached us, who have expressed complete willingness to be regulated under both the Investment Securities Act and have their funds subject to the Securities Act.

Mr. CARY. There are some insurance companies, I think the outstanding one being Metropolitan, which did not want to get into the variable annuity business at all.

Mr. KEITH. That is understandable.

One other observation: If you were to draw a similar chart from the Comptroller's point of view, Mr. Saxon's point of view, I think he would point out that historically the banks have served as trustees for welfare funds who do invest in speculative securities, and that you haven't exercised any jurisdiction over that, and that the extension of this to mutual funds was a normal phenomenon.

I think he would also point out that the banks had served as trustees for individuals and that there had been in fact commingling of those funds, and that this extension of the banks into the mutual fund business and investment into investments is just as natural from his point of view as it is from yours.

Mr. CARY. That is the argument that certainly the Comptroller and banking people would make. But there is a distinction which actually was firmly in the minds of the Federal Reserve Board during all the years it was in charge of this regulation, which regulation, by the way, has now been shifted to the Comptroller of the Currency.

The Board said, in effect, that it is true that a bank may act as fiduciary or trustees for individuals. It further said that, if the trusts are small, you may go so far as to commingle in the sense of having a common trust fund, if you are operating in a fiduciary capacity.

But the Board also said: You may not go beyond that. You may not go beyond the fiduciary role which you have had.

Now this is the big step: merchandising trust units as media of investment—merchandising an interest in a pool of securities, going out and selling it, in effect, to your depositors and other people.

This is the line. It is at this point that we say the banks have moved into the mutual fund business . At that point, it is not a question of bank expertise any more than in any other case where the bank is acting as an investment adviser and the sponsor of a mutual fund.

Mr. KEITH. Are you aware that the Senate apparently, at least the Subcommittee on Independent Offices, has reached a different conclusion than that which you have just expressed?

Mr. CARY. Yes, sir. We had questions on this issue before an Appropriations Subcommittee in the Senate.

When our apropriation figure came to our attention a few days ago, we found a statement in the committee report to the effect that no part of these funds shall be used for the administration of activities relating to banks and the mutual fund industry.

I think that report is being subjected to some question and scrutiny in the Senate. I do not know what conclusion the Senate will reach. But the report was handled by the Appropriations Committee. The matter has never had a full hearing before the appropriate committee in the Senate, and obviously in the House, because this is the committee for that. It is only on the appropriations side that it had this scrutiny.

Also, a Government Operations Subcommittee under Congressman Fascell about 6 months ago, or a little longer, also made a study of this and we testified before that subcommittee.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. HEMPHILL. I would like to ask one question.

If the insurance company sets up a fund and then, in turn, is adviser to the fund through its financial experts, actuaries, and what-not, then doesn't the whole activity of the insurance company automatically come under your supervision?

Mr. CARY. No, sir. Only the activities relating to that separate fund, because all the rest of the insurance company's problems are related to business which involve fixed dollar liabilities; whereas, this is not a fixed liability. It is an economic interest that a person will have in a pool of securities, which fluctuates in value with the value of those secuirties. True, it has an annuity factor and, therefore, has an insurance element. I don't deny that, but it is basically an interest in a unit, in a pool of securities, which will vary. In fact, that is the basis upon which the variable annuity is sold. It is attractive in the event that inflation occurs or the value of the securities goes up.

Mr. HEMPHILL. And your Commission will determine when he puts on the hat?

Mr. CARY. That is correct, if he puts on the variable annuity or mutual fund hat.

Mr. HEMPHILL. Thank you.

Mr. KEITH. I think the record should show one other aspect.

You don't mean to indicate that you don't have responsibility for those stock companies otherwise complying with the act as to capital and stockholders?

Mr. CARY. I was only relating myself at the moment to this question of the variable annuity and the Investment Company Act. Obviously, we have a different problem in connection with the very bill we are here testifying on involving the application of certain disclosure provisions to stock insurance companies.

Mr. KEITH. It would not affect the companies, with a mutual character?

Mr. CARY. We would have no connection with mutual companies under the first part of our proposed bill.

Mr. STAGGERS. Mr. Harris.

Mr. HARRIS. Now if I may resume, I think you might want Mr. Loomis to sit with you at the table because I will ask you some questions now about the controversy with which you are familiar, which has not been resolved. With your efforts, my efforts, and other efforts, it has not been resolved. I think we had better find out just what the situation is.

I told you about the questions raised by the attorneys general of the States.

The letter that I have, Mr. Loomis, pursuing the course that I raised a moment ago as to the broad general powers and the preemption problem, this attorney general says they are advisers to the various group departments, boards, and agencies of the States, which, as you know, is true. It says:

> I am, of course, vitally interested in any legislation pending before Congress that might directly or indirectly affect the regulating powers of such agencies.

Again I will ask you, is it your contention that this legislation will in no way affect directly or indirectly the regulating powers of these agencies?

Mr. CARY. I think I can speak to that. Mr. Loomis will speak more thoroughly, perhaps, if it is necessary.

Our view is that in connection with the first part of the bill requiring disclosure and the application of proxy rules, and the insider trading provisions, in general this will not in any way affect the jurisdiction of the superintendent of insurance of the State with respect to stock insurance companies.

Mr. Loomis will confirm that.

Mr. HARRIS. You said that with reference to the first part.

Mr. CARY. The first part is the only part that relates to insurance companies, sir, and that is why I thought that was what you were referring to. That is the only reason I limited it to the first part, because it is only the first part of the bill which basically focuses on insurance companies as one type of industry over which the disclosure provision should become operative.

Mr. HARRIS. Is it correct for me to assume that you have no intention by this legislation to affect, directly or indirectly, the regulating powers of such agency?

Mr. CARY. That is correct.

Mr. HARRIS. If an amendment was prepared and included in this legislation which states exactly that, would you object to it?

Mr. CARY. We would not object.

Mr. HARRIS. I do not know my own feeling about it as to how it is possible, but I wanted to ask the question.

Mr. CARY. Yes, sir. We would not object.

Mr. HARRIS. I think it is Aesop's Fables, where the man jumped on the horse and started in both directions at the same time. I do not believe we can do that.

He goes on and says:

In this instance I am specifically concerned with the continued regulation of insurance companies by State Boards of Insurance.

Insofar as you are concerned, he need have no concern?

Mr. CARY. That is correct, sir.

Mr. HARRIS. The letter says:

Congress, by the enactment of the McCarran Act, recognized that the regulation of the insurance industry was a Government function which should be left to the States.

Is that true?

Mr. CARY. That is generally correct, yes, sir. It doesn't mean, for example, sir, that when an insurance company goes to the market for funds, it doesn't file a registration statement with our Commission under the securities act of 1933. So it is correct in principle. But I do want to make it clear that the McCarran Act doesn't apply so completely across the board that there is no Government activity, Federal Government activity, which does not relate to it.

Mr. HARRIS. As you see it, there should be no conflict?

Mr. CARY. There should be no conflict.

Mr. HARRIS. From what you know about them in all the States, do you feel that insurance companies are properly regulated and supervised in the States where the responsibility is left to the States? I am not asking this for an embarrassing question at all.

Mr. CARY. In general, our answer is, sir, that we have no reason to believe that the superintendents of insurance are not doing a good job in protecting policy holders, and that is their job. We are moving on to our interest, the holders of $20 billion in stock in those insurance companies.

Mr. HARRIS. Mr. Hemphill just reminds me that if they are buying stock at all, is it not essential then to protect the bank holders?

Mr. CARY. We think, by the same token, it is essential to protect the bank holders and that is why this bill would apply to the owners of bank securities as well. Indeed, that is one of the basic reasons, Mr. Chairman, why we devoted a considerable amount of time in our statement to these separate industries, because we did not feel that any industry really had any basis for special treatment or special exemption. We feel, really, that this bill should be across the board.

Mr. HARRIS. I will ask again, because this letter raises the question: Would this legislation weaken the authority and the powers of the State agencies in this field over insurance companies?

Mr. CARY. We do not believe it would weaken them. I would like to point out what it does, lest I in any way be failing to convey the whole point.

As you know, this bill will require certain information to be filed with us, but we have stated in this statement and otherwise that it would be information presently available in the files of the insurance company. Moreover, 99 percent of the financial information will be already in the hands of the superintendent of insurance of the particular State. The bill also requires a proxy statement. Now it is true that, if a superintendent of insurance hasn't required a proxy statement in the past, this will add a duty which the insurance company must fulfill. But it doesn't in any way preempt. If a State authority

wants to have a proxy statement that is even more severe than the one that we propose, then under those circumstances he may go ahead and prescribe it.

Mr. HARRIS. I was going to go on with that. It says the annual statements of insurance companies filed with the 50 State departments are voluminous, searching, and detailed. These annual statements are public records, available for review by the public, the press, legislatures, trade publications or any one who wants to see them. They are on file in more places and more convenient to the public, such as the State capitals, than they would be from SEC filings in Washington.

Mr. CARY. We would take issue with that. We have no doubt that it is public information, but it isn't widely enough disseminated. That is our view. I think not, if reports are filed with us and if we take the further steps contemplated at this moment to insure that the material filed with us is more widely disseminated than it has been in the past, it will get out into more hands than it would if it were simply held as one report in the hands of the State superintendent of insurance. We have facilities already for duplicating it, photostating, and so forth.

Mr. HARRIS. You do not disagree with the statement with reference to the filings in the various 50 States?

Mr. CARY. No, sir.

Mr. HARRIS. What advantage would there be to have the same filing, the same information, with SEC?

Mr. CARY. There would be two advantages, sir. One, there would be a certain amount of supplemental information that would be filed with us that is not filed with the superintendent of insurance. It is primarily nonfinancial information and relates particularly to activities of the company of major importance, such as new issues of shares or a merger. Information would also be disclosed on transactions by "insiders" with the company; this is frequently not required in State insurance reports.

Secondly, besides having this additional information, we believe that there would be a wider dissemination of the information if it is available in our hands as well as being in the hands of the State superintendents of insurance.

Mr. HARRIS. They are regularly examined in the various States or by examiners representing the National Association of Insurance Commissioners, I believe.

Mr. CARY. That is correct.

Mr. HARRIS. Would you expect the examination reports to be filed with you?

Mr. CARY. I do not believe so, but may I check with our chief accountant, Mr. Barr, who has been dealing with the insurance industry for 25 years? I think he could give an exact answer to that.

Mr. BARR. Mr. Chairman, it would not be expected. We occasionally have such reports submitted to us for our information, but it would not be expected that they would be field with us. Those examinations are done about once every 3 years, so it is not an anuual examination.

Mr. HARRIS. It raises the question of duplication which you mentioned a moment ago. As I have understood, you have made it very

clear that a copy of the financial report would be filed with SEC and that would be sufficient.

Mr. CARY. We have gone almost that far, Mr. Chairman. We did say that we thought that there should be a historical analysis of surplus which, in addition, should be filed, which would be helpful to people buying the stock of an insurance company but which would not be of interest, as such, to a State insurance commissioner who is only interested in the policyholder. However, that information is obtainable from the information they have and would not be a major effort on their part.

I would like to ask Mr. Barr to confirm this.

Mr. Barr has one other point to make.

Mr. BARR. That would be required, and also a series of notes which would explain some of the technical terms used in the insurance industry for the benefit of the uninitiated.

Mr. CARY. That is all of the additional financial information that we would expect, sir.

Mr. HEMPHILL. How could you have a historical analysis of the surplus unless you had reports back over a number of years?

Mr. BARR. The company can prepare a supplemental analysis to the figures they have in their balance sheet.

Mr. HEMPHILL. I understand that, but I understood you to say that you would get that from the information they would normally file with the State insurance commissioner. Did I misunderstand?

Mr. BARR. This is a supplemental analysis which the company can prepare and have prepared in filings with us up to now.

Mr. HEMPHILL. But you could not get it from the reports?

Mr. BARR. You could not get it yourself.

Mr. HEMPHILL. They would have to make available the additional information?

Mr. BARR. Yes, sir.

Mr. CARY. That is the additional information they would have to file.

Mr. HEMPHILL. Thank you.

Mr. HARRIS. Could the SEC under the broad powers of rulemaking authority exercise supervisory control over the operations of insurance companies?

Mr. CARY. No, sir.

Mr. HARRIS. That is impossible?

Mr. CARY. That is correct. This is purely a disclosure statute.

Mr. HARRIS. Does the bill give the SEC authority to define assets in relation to insurance companies?

Mr. CARY. No. Mr. Barr said "No," too.

Mr. HARRIS. Does it provide authority or give the SEC unlimited authority to prescribe rules and regulations concerning the definition of assets, and so forth, in the public interest?

Mr. BARR. There is a general provision, but we have implemented that so far as insurance companies go by a specific reference to the requirements of the States. We have a rule in the book now with respect to casualty and fire companies. Any proposal on life companies would include the same rule.

Mr. HARRIS. I am reminded that the Interstate Commerce Act, and I have it here subject to the provisions of section 20 of that act, includes it in the law and not the rule.

Would you have any objection to that?

Mr. CARY. We had this question before us in the Senate, Mr. Chairman. We said at that time that we would definitely prefer to have this broader approach in the statute with confirmation by letter to the chairman of the Senate committee—which we gave at that time—as to how we were going to handle it. Basically, if that came to be an issue of major importance, and you feel that it is absolutely imperative, we would yield. But we do believe that there is a certain amount of flexibility that should be available in connection with our statute so that, if the insurance industry desires to change accounting provisions, we wouldn't want to have it built into the statute that the financials have to be handled one way. That is a result we would like to avoid.

There are 50 jurisdictions, Mr. Barr also reminds me. One would not want to discourage any particular State from setting higher standards.

Mr. HARRIS. Then can we, this committee, Congress, and the industry, understand from your knowledge of this, and you certainly are thoroughly familiar with it, that you do not propose here anything that would "fly in the face of the McCarran Act through which Congress vested the States with regulatory authority over insurance companies"?

Mr. CARY. That is correct, sir.

Mr. HARRIS. That is correct?

Mr. CARY. That is correct.

Mr. HARRIS. Now, with reference to the financial statements, this letter states: "The Chairman of the Securities and Exchange Commission has indicated that the effect of this bill on life insurance companies would be that such companies would file with the SEC the same financial statements which they now file with the State insurance commissioners, with some additional supplemental information."

Is that true?

Mr. CARY. That is correct, the historical analysis of surplus which I mentioned a moment ago, sir, and the explanatory notes. That would be the only supplemental information, sir.

Mr. HARRIS. And the proxy?

Mr. CARY. I am sorry, I am limiting myself in my discussions right now to the reporting of financial information with respect to a company. The proxy rule application would be a separate matter, but that would not involve any additional financial information than what an insurance company normally would produce.

Mr. HARRIS. It says further, "I understand that a rule has been proposed by the Commission providing that the present annual statements could be filed by life insurance companies in lieu of the financial information required under the rules and regulations of the Commission."

Mr. CARY. Mr. Barr will speak to that.

Mr. BARR. That is a misunderstanding. There is no rule proposed at this point exactly along that line. However, we have accepted such statements. We have moreover, proposed an amendment to our

accounting regulations as Chairman Cary has explained, which would take care of this problem.

Mr. HARRIS. The letter also states, and I merely mention this for information, that the information is currently available in all the States, and, in addition, financial information for particular companies are summarized or condensed from the annual reports in an accurate form by a number of respectable insurance reporting services.

Mr. CARY. Yes, sir, some of these companies do appear in Best's Insurance Manual, which I suppose is the leading one.

Mr. HARRIS. He mentions Best's Insurance Reports.

Mr. CARY. Yes, sir. First of all, we think it doesn't cover all of the companies which would be covered under this bill.

Second, we believe that if it is filed with this Commission, it is much more likely to be available in those financial reports.

I don't underestimate these reporting services' value. I think one of the most important things for us is not just to have it filed with the SEC, but for us to see that it gets in the reporting manuals, because they are used all over the country.

Mr. HARRIS. I asked you this morning about mutual companies, and you explained that you did not have jurisdiction over them, and that is understandable. But I did raise the question of the competitive nature of mutual companies with stock companies. This letter also raises this question.

It says, "I do not understand the reason for this exemption since many of the large insurance companies are mutual companies. The SEC erred in stating that 'the same need for investor protection does not exist for mutuals'."

Have you ever made a statement of that kind?

Mr. CARY. We didn't make that statement, but we do say that mutual insurance companies are not included under this bill because the buyers in mutual insurance companies are fundamentally buying insurance. That is the first point. They are buying an insurance policy and not stock. Furthermore, because there is no stock, there is no trading in the stock.

On the other hand, in stock companies, investors may be stockholders without even having an insurance policy in the company.

In stock companies, we are interested in providing information to people who are engaged in trading in that stock. They must have the information. In mutual companies, there are no shares being traded and, therefore, they don't need to know this kind of information. That is why we draw a distinction, Mr. Chairman, between mutual insurance companies, on the one hand, and stock insurance companies, on the other.

Mr. HARRIS. In other words, if there is no public trading, then any management abuses are none of your business?

Mr. CARY. They are none of our business legally, that is correct.

I think the answer will be yes. It is not that we are not unhappy.

Mr. Loomis has clarified that in my mind by pointing out that, since the holders in mutual companies are policyholders, any wrongdoing would be the responsibility of the State superintendent of insurance.

Mr. HARRIS. As a matter of principle, don't you think that—and I recognize they are not under your jurisdiction and, therefore, it is getting a little far afield for you—the disclosure and proxy solicita-

tion practices and so forth should be made public or available regardless of what the business is?

Mr. CARY. Well, sir, our jurisdiction has always run to stockholders or investors and to that extent we have always said that investors and stockholders should have the knowledge on which to base their decision as to who should be their directors and officers.

As to whether or not that same policy should apply in the mutual field, I suppose just purely on rational or logical grounds, it would seem so. But I don't think we have ever considered this question and I can't really speak for the Commission on that point because it has just been beyond our jurisdiction.

Mr. HARRIS. I realize that is getting a little far afield, but I cannot help giving my own opinion that where the competition in the field is as great as it is, it seems to me the uniform principles should be applicable.

Mr. CARY. We take the position, Mr. Chairman, that if a company has decided to proceed by way of being a stock company in which the public has an investor interest, then the principle that the investors or stockholders ought to have knowledge about whom they are voting for should be applicable across the board.

Mr. HARRIS. That seems to me to be just a matter of right.

Mr. CARY. That is the philosophy of the proxy rules.

Mr. HARRIS. I have just one or two others here.

The question has been raised also as to the effect this would have on small insurance companies. I think your answer to that is that those with 750 stockholders and $1 million in assets would be the ones that it would be applicable to.

Mr. CARY. That is correct, sir. We have furnished some information, I believe, as to the size.

We had at page 36 of my statement, Mr. Chairman, in the study's analysis of insurance companies meeting the statutory tests, over 50 percent had $10 million of assets; at the lower end of the scale only 18 percent had between $1 and $2 million of assets.

Mr. HARRIS. But that 18 percent or less percentage could be vitally affected. Is it true that the initial registration cost would vary from $30,000 to $65,000?

Mr. CARY. No, sir. I think the assumption that some people seem to have is that we would require an independent certified public accounting of the financial statements of the insurance company. The facts of the matter are that with the kind of registration we contemplate, and which I have assured this committee, the cost will be relatively small because we are not asking that there be any certification of the financial material. It can be prepared by the people on the staff of the insurance company, and, because it only varies in small part from the material filed with the State superintendent of insurance, in our opinion the cost will be relatively slight—in the nature of a few thousand as distinguished from the large amount you have indicated.

Mr. HARRIS. If the information filed with the State office contains the information and it is only supplemental which you need, would certified copy of that statement filed with your Commission meet your requirements?

Mr. CARY. With these exceptions, and may I divide it in two parts. On the financial information, two things: One is the explanatory

notes that Mr. Barr referred to; and two, the analysis of the historical analysis of surplus.

Those would be the only two things on the financial statement that would be additionally necessary.

Two, on the nonfinancial, information which would be prepared by the staff of the company, there would be certain additional information with respect to, for example, inside transactions, with respect to any action that has been taken of a major nature during the year, such as a merger or an issue of a large amount of stock. That would have to be taken care of by a special report and, of course, the proxy statement.

With those limited exceptions on the financial side and on the nonfinancial side, all that is necessary is the filing of the material, which is in the hands of the State superintendents of insurance. I have so stated that in the statement.

Mr. HARRIS. It is contended to meet the additional expense, typical whole life premiums averaging $20 per $1,000 would have to be increased to $21.50.

I do not know where the estimate comes from, but that is what they contend. I think it is a very important item.

Term life premiums of $6 would have to go to $7.50, in stock life companies having $10 million of either such insurance in force.

Are you in a position to state whether or not, from your information, that is correct?

Mr. CARY. In our opinion, that simply doesn't make sense. The amount of cost that would be involved to produce the material that would be filed with us, which is not already in their hands and in the hands of the State superintendents, would be sufficiently small that we think the cost would be in the neighborhood of a few thousand dollars at the most. Under those circumstances I can't believe that, in a company of any magnitude, the cost would not be a matter of mills as distinguished from additional cents. I think it would be exceedingly small.

Mr. HARRIS. Mr. Chairman, at my suggestion, you were very kind, and your group, to see the representatives of the State insurance commissioners of the United States. There were several of them that called on you and had quite extended conferences with you and others. As you know, they had conferences with me.

Mr. CARY. Yes, sir.

Mr. HARRIS. This matter has been thoroughly discussed in an effort to try to resolve the controversy. But apparently, insofar as agreeing to the procedures under the proposal, it has not been. Insofar as the record is concerned, as made here, there should not be such grave concern. I think we have made a record here today, and in view of the extended conferences which you and your group have had with these people, and which I have had, and others, I think it is such that those who had different viewpoints should become well prepared in order to expand on their viewpoints in order that this record may be completely made.

I believe, Mr. Chairman, so far as I am concerned, that makes the record about as complete as I think I can help make it at this time.

Thank you very much.

Thank you very much and I am sorry to have utilized so much of your time.

Mr. CARY. Thank you, sir.

Mr. STAGGERS. I am sure that Chairman Harris has certainly helped to make the record and asked many questions which should have been asked. There are probably a lot of other questions which should be asked.

I have two or three to pose now and will appreciate it if you will stand by later to answer further questions from the committee.

Mr. CARY. I shall be glad to, sir.

Mr. STAGGERS. In order to complete this phase of the record, I would like to ask just two or three. One of them has to do with the insider interest which Mr. Harris mentioned.

In the course of our hearings on House Joint Resolution 438, questions were asked concerning the protection afforded investors by various rules of the exchange relating to positions in other firms, which the members of the exchange might hold subject to the approval of the exchange, such as officers and directors of nonmember corporations. I wonder what the Commission has found with respect to the need for strengthening the rules in connection with possible conflicts of interest which may arise herein and in this connection?

Mr. CARY. Mr. Chairman, I would like to ask Mr. Cohen to speak to that.

Mr. COHEN. The problem of a director who is in the securities business is one to which the study report referred and suggested that both the exchange, the other self-regulatory institutions and the Commission address themselves——

Mr. STAGGERS. I cannot hear you, Mr. Cohen. Would you start over again, please?

Mr. COHEN. The study did refer to a problem which might exist when somebody in the securities business also acts as an officer or director of a nonfinancial company.

The recommendations were to the effect that the SEC and the various institutions involved should address themselves to a study of these problems with the idea of developing appropriate rules and statements of policy to avoid possible conflicts which may be to the detriment of investors.

Mr. STAGGERS. In regard to that, I wish to insert into the record at this point an article by Louis M. Kohlmyer of the Wall Street Journal, dated June 10, 1963, which states that the Commission at that time was undertaking to wrestle with this problem and had gone to some length in solving it.

I will insert this into the record. I am sure you are familiar with that article.

Mr. COHEN. I believe that that article refers to a particular aspect of the business. That is with respect to those persons who are in the securities industry and who may be associated with small business investment companies.

I think the article discussed the approach to the problems involved by the Small Business Administration and the author's understanding of the approach of the Commission in a similar area. This matter then became the subject of hearings before another committee.

Mr. STAGGERS. It may say something about the Small Business Administration, but I did not see it. It starts out with: "New moves are afoot and the Securities and Exchange Commission will likely cause many a house officer to give up his seat on a corporate board of directors."

Mr. CARY. It may be as a result of a case which came before this Commission, in which I wrote the opinion, called Cady Roberts & Co. I am not sure but what the article may be a discussion of the implications of that case.

That case, itself, has raised substantial questions with respect to the use of inside information by persons who are associated with a securities firm and also a director of a company. That was a step which we took, in an interpretation of rule 10(b)(5), which has had very substantial impact in the securities industry.

(The document referred to follows:)

[From the Wall Street Journal, June 10, 1963]

STIFF RESTRICTIONS ON BROKERS DOUBLING AS CORPORATE DIRECTORS STUDIED BY SEC

(By Louis M. Kohlmeier)

WASHINGTON.—New moves afoot in the Securities and Exchange Commission will likely prod many a brokerage house officer and partner to give up a long-cherished possession—his seat on a corporate board of directors.

"This is a problem that's been latent for years," says a high SEC official. "It's full of potential conflicts of interest."

A broker who is a corporate director inevitably obtains information at closed door board meetings that isn't available to the general public. That's when, in the SEC's view, this conflict arises:

If he uses the information for the benefit of his brokerage house and its customers, he may be violating his obligations to the corporation, and may even run afoul of the fraud provisions of the securities laws.

If he keeps the information secret, he may be violating his legal obligations to his brokerage customers.

WARNING ON PITFALLS

"We're not suggesting that brokers shouldn't be on boards," the SEC official insists. "But when they are, they should be aware of the obligations and pitfalls."

The legislative package the SEC sent Congress last week didn't contain a recommendation that would flatly bar brokers from corporate boards. The SEC official suggests the practice is so deeply embedded the staff felt there was little chance the lawmakers would outlaw it. But the moves the SEC has in mind may so restrict brokers' activities as directors that many under pressure will resign from boards.

In fact, the SEC's special stock market study staff already has observed evidence that "some firms are disengaging from their directorships partly as a result" of a groundbreaking decision in 1961 in which the Commission suggested that a broker-director who feels he can't disclose inside information had best "forgo" doing any business in the corporate stock involved.

The SEC, in some subsequent package of recommendations to Congress, may ask the lawmakers to tighten a restriction that already applies to broker-directors.

And, before then, it may propose some rules it could write under present law.

But the Commission's main push will be on the New York Stock Exchange and the National Association of Securities Dealers.

The SEC wants, first, an industry study of the whole "conflict of interest" potential, and then it wants the Big Board, which dominates the exchage market, and NASD, which polices the over-the-counter market, to write rules defining the obligations of members who serve as corporate directors.

BIG BOARD-NASD STUDY SEEN

"There definitely will be a study," probably as a joint exchange-NASD project, says the SEC official. The Commission has broad supervisory authority over both industry units and their rules of conduct for member brokers.

The rules the SEC is thinking about apparently would make the Big Board and NASD the final arbiters on whether a broker could retain a directorship. The New York Exchange, since the SEC's 1961 decision, has issued two "educational circulars" to members concerning directorates, but neither the exchange nor NASD has ever ordered a member off a corporate board "that I know of," says another SEC insider.

The Big Board did, according to the SEC, recently fine a member $1,000 for violating an exchange rule requiring members to "adhere to the principles of good business practice." The member learned from the president of a corporation of which he was a director that the corporation was going to offer to buy some of its own stock at $15 a share. The member quickly bought 5,000 shares in his wife's name at an average price not exceeding $10.50.

Despite the Big Board moves, the industry self-policing units have left many facets of the broker-director problem "virtually untouched" and NASD "apparently has never addressed itself to the conflicts involved," the SEC's stock market study staff recently reported to Congress.

The exchanges and NASD, besides becoming the final arbiters of broker-director conflicts, could write specific guides to conduct, in the form of policy statements or rules.

For example, another SEC official suggests, a policy statement might deal with the particular obligations of a brokerage concern that sponsors trading in the stock of an over-the-counter corporation while one of its partners is simultaneously a director of the corporation.

A rule might forbid a broker to hold options to buy the stock of a company on whose board he sits; currently, "it's common in the over-the-counter market for these directors to have options, but the practice intensifies the potential conflicts of interest," the SEC official says.

The stock market study staff's call for "incerased regulatory vigilance" over brokerage-directors, which is the basis for the Commission's drive for new policies and rules, will affect more than 1,000 of the Nation's estimated 6,000 brokerage concerns, and perhaps several thousand corporations.

The SEC study staff asked nearly 5,000 brokerage concerns about their directorships. It found 476 had officers or partners who were directors of corporations listed on an exchange, and 995 were represented on boards of one or more over-the-counter corporations—those whose stock isn't listed on exchanges.

Some brokers were represented on boards of both listed and unlisted corporations; hence the SEC has no total of brokerage concerns that are represented on boards.

Nor does it have a figure on the total number of corporations with brokers on their boards. But one SEC staff member agreed the tally is at least "several thousand."

The study staff noted that, while many brokerage concerns are represented on only 1 or 2 boards, more than 100 securities houses, including some of the largest, are represented on the boards of at least 10 corporations. For example, Bache & Co. was represented on 23 listed and 29 over-the-counter companies. Lehman Bros. had directorships on 58 listed and 23 over-the-counter companies. Paine, Webber, Jackson & Curtis was on boards of 24 listed and 29 over-the-counter companies.

Testimony the study staff took at private hearings found that brokers frequently feel they should be on the boards of corporations just going public, to keep abreast of corporate developments. They're also on the boards of established corporations to advise on such matters as dividend policy, debt structure, and the use of excess corporate funds.

The staff conceded many investment brokers "perform valuable services" and that frequently their services are sought by the corporations. But, "looking at the other side of the coin, there is no doubt that board representation may also be of benefit to the broker-dealer firms themselves," the staff declared. It said brokers themselves had testified they sometimes go on boards to obtain a corporation's future underwriting business, to enhance the brokerage concern's reputation, and to obtain inside corporate information that might be of use in the brokerage business.

The staff also found that "many" brokerage concerns go on corporate boards only reluctantly, "due to an awareness that conflicts of interest may arise when this function is combined with many of the normal activities of the securities business."

This reluctance, the staff suggested, may have increased since a 1961 SEC decision that a partner of a big board member firm violated the antifraud provisions of Federal securities laws when he transacted in a stock for his wife's account on the basis of advance information of a reduction in the corporation's regular dividend. The information was received from an employee of the member firm who was a director of the corporation, the SEC said.

INSIDE DATA KEPT SECRET

Some brokerage concerns, the SEC staff said, attempt to isolate knowledge their partners receive as directors. For instance, the staff said a partner in Kidder, Peabody & Co. testified that, while the firm may maintain positions in securities of companies of which a member is a director, the director isn't to tell his Kidder-Peabody partners any nonpublic information. In one instance, the staff said, such a partner-director kept to himself for 6 weeks the news of an adverse development in a corporation. The result was that Kidder-Peabody, which held a position in this corporate stock, took a "substantial" loss, the staff stated.

Carl M. Loeb, Rhoades & Co. takes precautions to insulate its securities trading department from confidential information by physically separating it from partner-directors. One of the concern's partners told the SEC staff that the partner in charge of the trading department is on the 16th floor and the other partners are on the 7th floor.

On the other hand, the study concluded, other brokers feel they're "entitled to us information obtained from board membership for the benefit of their customers and themselves."

The proprietor of Globus, Inc., "a small underwriting firm" that had 17 directorships, the SEC staff said, testified that when he receives inside information he transmits it to his salesmen for the customers to use. And he testified, this is "one of the reasons why I hope we will be a little more successful than other houses on the Street."

Mr. STAGGERS. It leads the public to believe that this is being taken care of and that it is a highly volatile situation.

Quoting just one paragraph further:

"This is a problem that has been latent for years," says a high SEC official. "It is full of potential conflicts of interest."

It goes at length in discussing the situation.

I think it is one thing that the SEC will have to go into.

I would like to bring up just briefly the broker-dealers. In chapter III of your Special Study, it contains a number of recommendations for new rules in the broker-dealer field for the protection of investors, including protection of customers' funds and securities and makes certain recommendations for additional recommendations. Among these are the recommendations that the Commission be required to empower the segregation of full margin and fully paid securities, to identify each customer's interest, and that section 6(e) of the Bankruptcy Act be amended to do this as well as require the Commission to require that an insolvent dealer be judged a bankrupt.

I would like to know, what is the Commission doing with respect to the segregation of these funds and securities?

Mr. CARY. Mr. Chairman, at this time, we haven't gone beyond discussion of it, recognizing some of the problems there. I would not know whether we would accept the recommendations made on that point in the Special Study. We recognize, primarily, if I am not mistaken, that it would require an amendment to the Bankruptcy Act, and that is not easy.

To be more specific, in our letter to Chairman Harris, we stated in connection with that very recommendation, which is recommendation 5, chapter III, part D, that we would simply hold it in abeyance and we would prefer to bring it to Congress at a later date. This would involve legislation, an amendment to the Bankruptcy Act. I think an amendment of that kind would require a very substantial amount of time and effort to achieve. As a consequence, at the present time we are not taking action on that particular recommendation.

Mr. STAGGERS. It was one of the recommendations.

Mr. CARY. That is correct, sir, in chapter III, as you say.

Mr. STAGGERS. I believe it might be well here to insert the provisions of the Bankruptcy Act having to do with the position of customers of a bankrupt broker-dealer.

(The information follows:)

The House Committee on the Judiciary Report 1409, issued July 29, 1937, at page 31, stated:

"*Stockbrokers.*

"Section 60e: Subdivision e has been added to section 60 in order to make uniform the rules applicable to the liquidation of the assets of bankrupt stockbrokers and to secure greater proximation to equality in distribution, especially to margin customers. Under the so-called Massachusetts rule the broker in margin transactions is the owner of the security carrying same upon an executory contract to sell, and the relationship is one of debtor and creditor. *In re Codman* (284 Fed. 273). The prevailing rule is that the broker is the agent for the customer when purchasing the securities, but in a margin transaction becomes in effect, if not technically, a pledgee. *Richardson* v. *Shaw* (209 U.S. 365).

"While the latter rule holding the broker to the liability of a pledgee is salutary and tends to prevent sharp practices and frauds, yet when the broker becomes bankrupt and the court must marshal his remaining assets for equitable distribution the rule becomes complicated, impracticable, and usually extremely inequitable (*In re Wilson*, 252 Fed 631). To secure practical equality for the margin customers, the trustee must be put in a position other than that occupied by him under the prevailing rule. Under this prevailing rule, the margin customer's rights depend largely upon the fortuitous circumstance that stock of which he is 'long' happens to be on hand, while that of another customer in exactly the same relationship may not be on hand. Furthermore, where the prevailing rule is the law, there is great incentive to the failing broker to escape liability for conversion and fraud by deliberately, in anticipation of bankruptcy, using all available assets to acquire securities to cover commitments to margin customers. Such action by the stockbroker is rarely invalidated because of its deliberate fraud, and is usually upheld upon the ground that the broker is presumed to be exercising his right in fulfilling his duty to keep on hand enough stock to satisfy his customers (*Gorman* v. *Littlefield*, 229 U.S. 19).

"Few customers understand the technical intricacies of their reclamation rights; and, consequently, in the ordinary stock-brokerage bankruptcy some margin customers (whose claims are presented with the requisite technical proof) fare exceedingly well, but most of them, by inaction or ignorance, or the unfortunate status of the stocks of which they were long, are relegated to the position of unsecured general creditors.

"The provisions of the subdivision have been carefully worked out, will do substantial justice, and be exceedingly helpful in declaring the law on a most difficult and troublesome subject."

* * * * * * *

"(e) (1) Where the bankrupt is a stockholder, the following definitions and provisions of this subdivision shall apply: 'Property' shall include cash, securities, whether or not negotiable, and all other property of similar character; 'customers' of a stockbroker shall include persons who have claims on account of securities received, acquired, or held by the stockbroker from or for the account of such persons (a) for safekeeping, or (b) with a view to sale, or (c) to cover consummated sales, or (d) pursuant to purchases, or (e) as collateral security, or (f) by way of loans of securities by such persons to the stockbroker, and shall include persons who have claims against the stockbroker

arising out of sales or conversions of such securities; 'cash customers' shall mean customers entitled to immediate possession of such securities without the payment of any sum to the stockbroker; the same person may be a cash customer with reference to certain securities and not a cash customer with reference to other securities; the 'net equity' of a customer's account shall be determined by excluding any specifically identifiable securities reclaimable by the customer and by subtracting the indebtedness of the customer to the stockbroker from the sum which would have been owing by the stockbroker to the customer had the stockbroker liquidated, by sale or purchase on the date of bankruptcy, the remaining securities or security commitments of the customer.

"(2) All property at any time received, acquired, or held by a stockholder from or for the account of customers, except cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund; and all customers except such cash customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the date of bankruptcy: *Provided, however*, That such fund shall to the extent approved by the court be subject to the priority of payment of the costs and expenses enumerated in clauses (1) and (2)of subdivision (a) of section 104 of this title. If such fund shall not be sufficient to pay in full the claims of such class of creditors, such creditors shall be entitled, to the extent only of their respective unpaid balances, to share in the general estate with the general creditors.

"(3) Any property remaining after the liquidation of a pledge made by a stockbroker shall be apportioned between his general estate and such single and separate fund in the proportion in which the general property of the stockbroker and the property of his customers contributed to such pledge.

"(4) No cash received by a stockbroker from or for the account of a customer for the purchase or sale of securities, and no securities or similar property received by a stockbroker from or for the account of a cash customer for sale and remittance or pursuant to purchase or as collateral security, or for safekeeping, or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified, unless such property remained in its identical form in the stockbroker's possession until the date of bankruptcy, or unless such property or any substitutes therefor or the proceeds thereof were, more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to be physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy.

"(5) Where such single and separate fund is not sufficient to pay in full the claims of such single and separate class of creditors, a transfer by a stockbroker of any property which, except for such transfer, would have been a part of such fund may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this title. For the purpose of such recovery, the property so transferred shall be deemed to have been the property of the stockbroker and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding. If any securities received or acquired by a stockbroker from a cash customer are transferred by the stockbroker, such customer shall not have any specific interest in or specific right to any securities of like kind on hand at the time of bankruptcy, but such securities of like kind or the proceeds thereof shall become part of such single and separate fund: *Provided, however*, That a customer shall have a specific title to securities (a) which have been physically set aside by a stockbroker, more than four months before his bankruptcy or while solvent, in safekeeping for such customer, and so retained until the date of bankruptcy, regardless of the name in which such securities are registered, or (b) which a stockbroker, more than four months before his bankruptcy or while solvent, caused to be registered in the name of such customer."

* * * * * * *

Mr. STAGGERS. I would like to ask you this, then: Has the Commission sought to have receivers appointed for insolvent brokers and dealers?

Mr. CARY. We have, on several occasions when we go into court. For example, because of net capital deficiencies or because of the par-

ticular situation of a broker-dealer, we have asked the court, in order to protect customers' securities and customers' funds, to appoint a receiver in some instances.

Mr. Loomis has some cases in mind of that type.

Mr. STAGGERS. To save time, may I ask you to supply for the record, the cases, the number of cases, in which you have done this, that is, appointed receivers?

Mr. CARY. We shall be glad to do so; yes, sir.

Mr. STAGGERS. I would like you to supply for the record, the number of such cases where the Commission formulated a plan or proposal for the liquidation of the receivership.

Mr. CARY. Of a particular broker-dealer?

Mr. STAGGERS. Yes.

Mr. CARY. Yes, sir.

Mr. STAGGERS. Next what is the recommendation of the Commission for a general rule to determine the rights of all classes of customers and creditors in broker-dealer receivership liquidation proceedings.

Mr. CARY. Mr. Loomis informs me we haven't really gone that far. Mr. Chairman. If there is anything to be supplied, we shall do so, but it is our opinion that we haven't gone that far.

Mr. STAGGERS. Fourth, the Commission recommendation as to whether there should be statutory authority for Commission participation in broker-dealer receivership cases, comparable to the authority exercised in bankruptcy cases.

Mr. CARY. That would be the kind of advisory role that we occupy in "Chapter X: Reorganizations," I assume, and we have not gone that far nor have we in my tenure here thought of asking for such legislation.

Mr. STAGGERS. I wish you would furnish those four things, if you can.

Mr. CARY. We shall supply that for the record and give you a precise answer; yes, sir.

(The information referred to follows:)

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION WITH RESPECT TO THE APPOINTMENT OF RECEIVERS OF BROKERS AND DEALERS

At the hearing on November 20, 1963, before a subcommittee of the House Committee on Interstate and Foreign Commerce on H.R. 6789, 88th Congress, Representative Staggers asked several questions with respect to the appointment of receivers in Commission actions against brokers and dealers. The purpose of this memorandum is to endeavor to answer those questions. The questions are as follows:

1. What is the number of cases in which the Commission has had receivers appointed for broker-dealers?

Our litigation records are not broken down by cases in which the appointment of receivers was sought and cases in which this was not done. Consequently, in order to answer Congressman Staggers' question it was necessary to review our files. We therefore examined all our litigation files dealing with actions against brokers and dealers during the past 5 years. For earlier periods we relied upon the tabulation of cases in Professor Loss treatise (Loss, "Securities Regulation," 2d ed., 1961). This review indicated that between 1943, which is the earliest date in which such a case was discovered, and November 15, 1963, receivers were appointed at the request of the Commission in a total of 62 cases brought by the Commission against broker-dealers. It appears that in 10 other cases the Commission's application for a receivership was denied, and in a number of additional cases the request was ultimately withdrawn as unnecessary or our records do not reveal whether or not a receiver was actually appointed.

The great majority of these actions were disposed of by the court without opinion. However, in *Securities and Exchange Commission* v. *H. S. Simmons & Co., Inc.* (190 F. Supp. 432, S.D.N.Y., 1961), a case in which the defendants contested the appointment of a receiver in an action brought by the Commission upon the ground that there was no statutory authority for such appointment, the court determined that its inherent equity powers permitted it to grant this relief. The court said:

"[1] While it is true that section 21(e) contains no express authorization to the Commission to apply for such appointment, 'when Congress entrusts to an equity court the enforcement of prohibitions contained in a regulatory enactment, it must be taken to have acted cognizant of the historic power of equity to provide complete relief in the light of statutory purposes.' Thus, the court's inherent equity power may be resorted to when necessary to prevent diversion or waste of assets to the detriment of those for whose benefit, in some measure, this injunctive action is brought. Although a general purpose of the suit is to protect the investing public from the consequences of continued violations of the act, a specific purpose is the protection of those who already have been injured by a violator's actions from further despoliation of their property or rights.

"As already noted, stocks of individual customers of the corporate defendant have been diverted and such assets as remain may suffer a similar disposition. Both customers and creditors of the defendants are entitled to have the status quo preserved pending whatever insolvency or other proceeding they may deem advisable in the protection of their respective interests.

"[2] Under the circumstances the court is justified in exercising its power to appoint a receiver to prevent further diversion of stocks and other assets and to assure compliance with the terms of the preliminary injunctive order, the case for which has clearly been made out."

In the recent case of *Securities and Exchange Commission* v. *The Keller Corporation* (323 F. 2d 397 (C.A. 7, Oct. 1963)), involving an inactive registered broker-dealer which, the court found, was also an investment company within the meaning of the Investment Company Act of 1940, the court of appeals determined that in a proper case a receiver could be appointed in an action commenced by the Commission even where the defendant was not shown to be insolvent. The court said:

"The district court was vested with inherent equitable power to appoint a trustee-receiver under the facts of this case. The prima facie showing of fraud and mismanagement, absent insolvency, is enough to call into play the equitable powers of the court. It is hardly conceivable that the trial court should have permitted those who were enjoined from fradulent misconduct to continue in control of Kellco's affairs for the benefit of those shown to have been defrauded. In such cases the appointment of a trustee-receiver becomes a necessary implementation of injunctive relief. *Los Angeles Tr. D. & M. Exch.* v. *Securities and Exch. Com'n.* (9 Cir., 285 F. 2d 162, 181–182 (1961), cert. denied, 366 U.S. 919); *Aldred Inv. Trust* v. *Securities and Exchange Com'n.* (1 Cir., 151 F. 2d 254, 260–261 (1945), cert. denied, 326 U.S. 795); *Bailey* v. *Proctor* (1 Cir., 160 F. 2d 78 (1947), cert. denied, 331 U.S. 834).

"Further, in reading section 42(e) of the act with section 7(a) in light of the purpose of the legislation, it is clear to us that Congress was evolving a statutory plan for the protection of the investing public. It is peculiarly applicable to the case at bar. Kellco was found to have been an investment company, operating unregistered and in violation of section 7(a) of the act, pursuant to a fraudulent scheme in violation of the fiduciary relationship running from the operators to their unsuspecting stockholders. It is readily apparent that the district court was vested with statutory power in addition to its inherent equitable power to appoint the trustee-receiver for Kellco.

"Having determined that the district court properly invoked its equitable jurisdiction, the court acted within its powers in granting to the trustee-receiver authority necessary to insure full and complete relief in light of the statutory purpose. The powers given the fiduciary in this case were appropriate for the protection of the stockholders. *Mitchell* v. *DeMario Jewelry*, 361 U.S. 288, 291–292 (1960); *Porter* v. *Warner Co.*, 328 U.S. 395, 398 (1946)."

2. Congressman Staggers' second question was: What is the number of cases where the Commission formulated a plan or proposal for the liquidation of the receivership?

We can recall no case in which the Commission formulated the plans for the liquidation of the receivership. The receiver is an officer of the court, appointed by the court, and responsible to it rather than to the Commission. It is his responsibility, rather than that of the Commission, to formulate a liquidation plan; and in so doing he is ordinarily guided by applicable equity receivership law. The Commission, as a party to the action, normally gives the receiver any advice and assistance which he may desire.

3. The next question related to the recommendation of the Commission with respect to a general rule to determine the rights of all classes of customers and creditors in broker-dealer receivership liquidation proceedings.

The Commission has made no recommendations with respect to the rules to be applied in equity receiverships, such as those discussed above, since such rules are generally based upon common law rather than statute. The Special Study of the securities markets recommended in chapter III. D at page 416 of part I of its report, that section 60(e) of the Bankruptcy Act, which is the primary Federal legislation determining the rights of customers and creditors in broker-dealer bankruptcy proceedings, should be amended in certain respects to clarify the principles for determination of the rights of customers under its provisions, as well as to clarify the scope of its application. The study also recommended that the Bankruptcy Act should be amended to empower the Commission to petition that an insolvent broker-dealer be adjudicated a bankrupt so as to insure the applicability of the Bankruptcy Act and thus of section 60(e), to liquidations resulting from actions brought by the Commission against insolvent brokers and dealers. A proposal similar to this latter recommendation of the study was included in H.R. 2480, 86th Congress, which was a part of the Commission's legislative program for 1959.

The applicable law with respect to broker-dealer insolvency under the bankruptcy laws is discussed by the Special Study at pages 410 through 414 of part I of its report.

The recommendations of the study referred to above and certain related recommendations are now being considered as part of the implementation of the study's proposals. They present complex and interrelated problems.

4. The fourth question related to the Commission's recommendations as to whether there should be statutory authority for Commission participation in broker-dealer receivership cases comparable to the authority exercised in bankruptcy cases.

The Commission is a party to any proceeding brought by it against an insolvent broker-dealer, such as the cases referred to in the answer to the first question, and, as such a party, it is entitled to participate in the receivership case and to urge upon the court or the receiver any position which it deems appropriate. In *East* v. *Crowdus*, 307 F. 2d 645 (C.A. 8, 1962), the court of appeals held that the Commission is a party in such a case and entitled to participate in proceedings relating to the disposition of the assets in the custody of the receiver. No general recommendation can be made with respect to Commission participation in equity receivership cases brought by private parties against brokers and dealers in State or Federal courts, since the need for such participation would depend upon the facts of the individual case.

As mentioned in answer to question No. 3, the Special Study has recommended that the Commission be empowered to petition for the adjudication of a broker-dealer as a bankrupt. If such legislation were adopted, the Commission presumably would be a party to the bankruptcy proceeding and be entitled to participate therein. Chapter X of the Bankruptcy Act expressly authorizes the Commission to partcipate in corporate reorganizations under that section as an adviser to the court. Our experience has not demonstrated a need for comparable legislation as to bankruptcy proceedings involving broker-dealers but not commenced by the Commission. Normally the liquidation of an insolvent broker-dealer does not present the complex questions of law, fact, and business judgment which are involved in a corporate reorganization under chapter X and which are the principal reasons for the Commission's statutory participation in reorganization cases.

Mr. STAGGERS. I just want to go back to the history of this legislation for a moment. Yesterday I asked you whether legislative proposals contained in these bills represent all of the legislation you felt necessary for the protection of investors. You indicated that this

was so except for the possibility of additional legislation on investment companies. I believe that is correct.

Mr. CARY. I said we thought, as we went over it, that we had no intention of asking for immediate legislation in other areas, except possibly, as I said, in the investment compaany field if our study should reveal the necessity for it.

Mr. STAGGERS. As you know, for a great number of years this committee has been interested in the protection of the investors, and have tried to be sure that he got all the protection that was necessary. We have continually requested the Commission for legislative proposals that might be necessary to give this protection.

In 1954, the Commission developed a legislative program which removed some of the onerous provisions of the law that were felt unnecessary for the protection of investors in the light of the Commission's 20 years of experience at that time.

At that time, this committee insisted on, and the Commission agreed to proceed with a program for bringing up those amendments which the Commission felt necessary to strengthen the securities laws.

By 1959, a program was developed by the Commission and presented to this committee.

As you perhaps know the legislative history, it passed the Senate and came to this House and was reported by this committee. It did not become law because of a time element and other things that were involved.

I am wondering, accordingly, whether, in view of those recommendations, and as I remember there were 11 specific recommendations for legislation in that bill made at that time as to the need for this legislation—and two of the Commissioners are now sitting on the front row who were here as witnesses at that time—just why so many of the proposals you had at that time are not contained in the present bill. As you remember, it was said that if they were presented, that is all the Commission needed in order to do a job.

To follow it up, for example, H.R. 2480, about which I am speaking, in the 86th Congress, had provisions pertaining to manipulations; namely, amendments to section 9(a) (1) and (2) of the act and amendments concerning the related matter of the extension of credit invloving amendments to sections 7(c), 11(d), and 14(b).

Do you feel that these are unnecessary at this time, or do you have the power to cover this subject by rulemaking, as was requested at that time? Do you have that power to cover these subjects in rulemaking?

Mr. CARY. I am going to ask Mr. Woodside to speak to that. As you say, he was here at that time and I was not. He has more expertise than I in that field.

Mr. WOODSIDE. Mr. Chairman, I confess that I have no fresh recollection of the details of that earlier program, except as I recall it I believe that it was characterized both within and without the Commission as a program of what you might consider to be technical amendments.

I believe that, by and large, many of them were fairly noncontroversial. The Commission did not undertake a review of that program in connection with its current efforts growing out of the market study, and the reason for that basically was stated earlier today.

As you must be aware, the Commission's energies and the staff's energies have been completely consumed in the last 2 years in producing this market study, and the program flowing from it. We were able, by dint of great effort and cooperation of the industry, to bring the principal fruits of that study into focus, into the present legislative program. There are always waiting in the wings, at any time amendments are proposed by the Commission, there are always six more which others want to have offered. It simply boiled down to whether we would focus on this program, which we considered essential, or whether we would broaden it out to include things that were mentioned earlier before the Congress, and other things that other people wished to propose, and thereby bog down in a long series of proposals which would have wound up, in my judgment, with nothing coming before the Congress this year. That is not to say that some of the technical amendments that were proposed before were without merit. As a matter of fact, without being able to specify, I think you will find that some of the amendments proposed in the 1959 program, I think it was, are embodied in this one, although they have not been highlighted in that respect.

I am sure that if we addressed ourselves to a general program of overhauling the acts generally, both the Commission and everybody else would have lots to say. But that would go on and on.

Mr. STAGGERS. Mr. Woodside, I asked a question and I do not believe it has been answered, but I will go to the next one.

I asked if you felt this coud be done by rulemaking.

Mr. WOODSIDE. As I say, Mr. Chairman, that is not fresh enough in my mind to answer that question.

Mr. STAGGERS. The next question is your proposal in 2480 contained proposals for broker-dealer responsibility by amendment of section 8 of the act and also to broker-dealer borrowing or lending of customer securities, by amendment to section 8(d). Do you feel these are necessary at this time or do you have the power to cover this subject by rulemaking?

Mr. WOODSIDE. I don't know that I can answer that.

Mr. LOOMIS. I believe, in view of the fact that we did at that time suggest that legislation was necessary, that we felt that we didn't have the power to do it by rulemaking I think that is still true, particularly in view of the fact certain self-regulatory agencies or otherwise might not be able to deal with some of these problems. I agree with what Mr. Woodside said, that we just didn't endeavor to join to this legislative program a technical amendment program covering all the matters which have been considered in the past, because it just didn't seem feasible at the moment.

Mr. STAGGERS. I have two or three more.

To me it is inconceivable that after 4 years of prodding by this committee that you come up with 11 recommendations which you thought were all important.

I remember the testimony, that if you got those, it would take care of the situation. They have gone by the board now. You have embodied one in this.

The next question is at that time you had certain suggestions for strengthening the provisions relating to the broker-dealer registrations relative to: (a), the baiss for which dealer revocation can be taken;

(b), sanctions which may be imposed by the Commission; (c), the conditions under which an application for registration may be withdrawn; and (d), the postponement of the effectiveness of an application for registration.

I am not sure just how far these same proposals are contained in the bill before us today and I wish you would comment upon them.

Mr. CARY. I think we will have to do that, if we may, Mr. Chairman, by a letter to you, or a separate statement to you. I don't think we are in a position to speak orally on that point.

I will generalize, if I may, further, on the points you have made, and your criticism is certainly well founded. On the other hand I will take some personal responsibility in this. When I came here, I felt that rather than going for a technical amendments program when we came to this Congress for legislation, we ought to do it on the basis of some broad general principles, stemming out of the Special Study and really approach it in that way. I think that accounts for our viewpoint. It may have been wrong but at least we had a philosophy on which our position was based.

Mr. STAGGERS. I have two or three more questions.

Of course, I do not agree with you on that.

Mr. LOOMIS. Could I just interject that the first two of those items that you mentioned, at least, the change in the basis for denial and revocation of registration and in sanctions, they are in this legislative program, and I think the third one is here, too.

Mr. STAGGERS. You are going to supply that?

Mr. CARY. We shall.

Mr. STAGGERS. At that time, you also had certain proposals for suspension of trading on an exchange and/or suspension or withdrawal of an exchange.

I am not sure just how far these same proposals are contained in the bill before us today and wish that you would comment upon them.

Mr. LOOMIS. I think that those should be included in the comments. The same proposals are not here, not all of them.

Mr. STAGGERS. All right.

In the same 2,480, which was before the House at that time, which passed through this committee, you proposed to aid your enforcement procedures by amending sections 21 and 21(b) for violations as a ground for injunction and concerning aiders and abettors.

Do you feel these are necessary at this time, or do you have the power to cover this subject by rulemaking?

Mr. CARY. I think the point that was made by Mr. Loomis a moment ago would be equally applicable: namely, that since we then were asking for legislative changes, we assumed at that time that we didn't have the power by rulemaking.

Secondly, to analyze this, I think we will have to do it by a separate statement.

Mr. STAGGERS. In addition, at that time you proposed to add a new section, 35(c), which would set out forfeitures for failure to file information with the Commission. This was touched by the chairman, Mr. Harris.

Do you feel these unnecessary at this time, or do you have the power to cover this subject by rulemaking?

Mr. CARY. We do not think we have the power. We have considered whether or not some penalty should be prescribed for failure to report. We decided in that particular instance that we would not ask for it at this time.

Maybe Mr. Woodside could speak to that one a little more in detail. Have you any other comments on that point?

Mr. WOODSIDE. As I recall, I testified before this committee in 1959 on behalf of the Commission in support of a statutory amendment which would authorize us to attempt to collect fines for the failure to file reports.

I think the short answer is that this Commission, No. 1, is not exactly enchanted with the idea of seeking to collect money fines for defaults. In fact, this program embodies an abandonment of a provision of the 1934 act which imposes a penalty of $100 a day for failure to file reports under 15(d).

I guess the short answer is that this Commission views the matter differently than the prior Commission, and we have not focused on the question of the desirability, really, of trying to collect money fines.

I would guess at the moment we would vote against it.

Mr. STAGGERS. I might repeat again that after 4 years of study and making the proposals before this committee, and this was requested by this committee, you proposed then a new addition to the law saying that this should be done and that the Commission should have the right.

I wish that you would answer all of these questions and present them to the committee, because at that time they were considered highly important and highly necessary to the SEC.

As one of the members has said, we spent a million dollars under your jurisdiction. You had broad authority and broad investigative powers to go into this whole subject. If these were important then, they are important today, and I do not see why they were not covered by the Study if they were important.

You say that they were not covered by the Study. Then we want to know why, because, after all, the Congress did vote the money. If you can answer these questions in writing, we would appreciate it.

I can understand your views, as they might have appeared now with less importance. But they were important then after a long period of study, when you said, "If we can get this, this is what we need, we can do our job." That is not too long ago.

The committee, I am sure, is trying to do one job, to protect the people of this country, for which they were elected, and to do the job and be fair to all people. I am sure you are doing your job exactly that way. That is the reason we have the hearings and the reason the money was voted and given to you.

I want to again congratulate you, Mr. Chairman, and all of your staff, for the able job you have done.

This is an important piece of legislation, and I know you do not hold it lightly, although some do and some say it does not need change and some would like to even throw the rules away.

We hope we can come up with something that will be equitable to the industry and to the people of this Nation.

I wonder if you would hold yourself in abeyance, so that we could have Mr. Funston on, and then come back to you later.

Mr. CARY. I will be glad to.

(The information requested follows:)

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON DIFFERENCES BETWEEN LEGISLATIVE PROPOSALS MADE IN THE 86TH CONGRESS AND LEGISLATIVE PROPOSALS MADE IN THE 88TH CONGRESS

At the hearing on November 20, 1963, before a subcommittee of the House Committee on Interstate and Foreign Commerce on H.R. 6789, 88th Congress, Representative Staggers inquired as to why certain amendments to the Securities Exchange Act of 1934, which were proposed by the Commission in the 86th Congress and embodied in H.R. 2480, 86th Congress, were not included in the Commission's legislative recommendations to this Congress. In particular Mr. Staggers referred to 11 specific recommendations for legislation. Those recommendations were enumerated in a document which was printed in hearings before a subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, 86th Congress, 1st Session, on Securities and Exchange Commission Matters, page 156. There follows an enumeration and explanation of each of those 11 proposals, a statement as to each proposal whether or not it is included in H.R. 6789 and if not included, an explanation of the reasons therefor.

In connection with this question, it should be borne in mind that the origin and purpose of the legislative program embodied in H.R. 6789 is quite different from that which was contained in H.R. 2480 in the 86th Congress. The purpose of the amendments to the Securities Exchange Act suggested in 1959 was to facilitate the Commission's enforcement of the statute by changing certain provisions which had created actual or potential enforcement problems; by clarifying certain ambiguities; and by codifying certain administrative interpretations of the act. By reason of its objectives, H.R. 2480 contained a substantial number of provisions which appeared to be rather technical, and during the consideration of that bill, considerable controversy developed as to the necessity for these changes.

H.R. 6789, on the other hand, was designed to carry out the principal legislative recommendations arising from the Special Study of Securities Markets, and proposes significant substantive changes in the statutory pattern for the purpose of raising standards in the securities markets. While H.R. 6789 contains a number of the significant changes which were also proposed in H.R. 2480, it was felt to be undesirable to include most proposals which had the appearance of being technical and which had not been considered or discussed by the Special Study. The Special Study did not believe its mandate to study the securities markets and the rules of the self-regulatory agencies included such legal—and to some extent technical—questions as whether or not there were ambiguities in the Securities Exchange Act which needed clarification or whether certain administrative interpretations should be codified. It is for this reason that a number of the proposals contained in H.R. 2480 were not considered by the Special Study. The Special Study, however, did consider such fundamental matters as the basis for Commission disciplinary proceedings against brokers, dealers, and their personnel, and the handling of customers' securities, which were the subject of legislative proposals contained in H.R. 2480 as well as H.R. 6789. While many of the proposals not included in H.R. 6789 have considerable merit, their inclusion would have complicated the legislative program and given rise to avoidable controversy. This would have further delayed consideration and action by the Congress upon the significant reforms proposed by the Special Study.

1. H.R. 2480 contained proposals to clarify and strengthen the provisions of the Exchange Act relating to manipulation and to the financial responsibility of brokers and dealers. That bill would have eliminated from section 9(a)(1) of the act the requirement that "matched orders" be "of substantially the same size" in order to constitute a violation. This proposal was directed at an enforcement problem which rarely arises and is somewhat technical in nature and for the reasons stated above it was not considered desirable to include such a proposal in H.R. 6789.

H.R. 2480 contained a recommendation to make the general antimanipulative provisions of the act and those related to stabilization applicable where one or more manipulative or stabilizing transaction is effected, without requiring proof of a "series of transactions." This proposal merely involved a codification in the statute of a principle already in effect under the Commission's rules relating to manipulation and stabilization.

H.R. 2480 would have transferred to section 8(b) of the act the provision relating to financial responsibility of brokers and dealers which now appears in section 15(c)(3) of the act so that regulations under the new section could be applicable whether a broker effects a transaction on a national securities exchange or in the over-the-counter market. This proposal would have had impact only on those few brokers who are members of a national securities exchange but not members of a national securities association. Although H.R. 6789 does not contain such a proposal, it does propose an amendment which would require all registered brokers and dealers to be members of a registered national securities association.

2. H.R. 2480 contained provisions to authorize the Commission by rule to regulate the borrowing, holding, and lending of customers' securities by a broker or dealer. This would have been accomplished by amending section 8(d) of the act to make it unlawful for members, brokers, and dealers to borrow, lend, or hold customers' securities in contravention of rules and regulations prescribed by the Commission to provide safeguards with respect to securities carried for accounts of customers. H.R. 6789 does not contain this proposal. The matter with which this proposal was designed to deal is one aspect of the broader problem of providing additional protection for customers' funds and securities held by broker-dealers. The broad problem was considered in chapter III.D of the Report of the Special Study and is now being considered as a part of the implementation of the study's recommendations. Pending resolution of the complex and interrelated problems presented by these recommendations, it was not deemed appropriate to include one part of them in a legislative program having a different primary purpose.

3. H.R. 2480 contained proposals to make it clear that attempts to purchase or sell securities are covered by the antifraud provisions of the act. This would have been accomplished by amendment of section 10(b) of the act to make it applicable to manipulative activities in connection with "any attempt to purchase or sell, any security." This amendment was proposed to clarify the existing statute and not to make any change in its substantive effect, and as pointed out above, for that reason the Commission does not believe it necessary to include such a recommendation in H.R. 6789.

4. H.R. 2480 contained proposals to amend the provisions of the act relating to broker and dealer registration with respect to (a) the basis on which action for denial or revocation may be taken, (b) the sanctions which may be imposed by the Commission, (c) the conditions under which an application for registration may be withdrawn, and (d) the postponement of the effectiveness of an application for registration.

H.R. 2480 would have added to the act as bases for disqualification from the securities business (1) conviction of a felony or misdemeanor involving violation of the mail fraud statute or involving embezzlement or similar crimes, and (2) willful violation of the Investment Advisers Act of 1940. H.R. 6789 would also add these as bases for disqualification, but in addition would include willful violations of the Investment Company Act of 1940 and the willful aiding or abetting of violations of the Federal securities laws as bases for disqualification. Furthermore, H.R. 6789 reflects the recommendation of the Special Study that the Securities and Exchange Commission be authorized to discipline an individual as well as the broker-dealer firm itself. This will allow the Commission to fit the sanction more appropriately to the conduct of all persons and firms involved, and, accordingly, would disqualify persons subject to an order of the Commission barring or suspending their right to be a person associated with a broker or dealer. In this respect, therefore, the recommendations in H.R. 6789 go beyond those which were contained in H.R. 2480.

Both H.R. 6789 and H.R. 2480 would have permitted suspension of registration for a period not exceeding 12 months as an ultimate sanction that may be imposed against a broker-dealer. However, H.R. 6789 would also allow censure of a broker-dealer as an ultimate sanction.

H.R. 2480 would have amended the act to provide that an application for registration may be withdrawn only with the consent of the Commission, if such application were received by the Commission after the commencement of a proceeding to determine whether to deny registration. This proposal represented a codification of existing administrative practices which were subsequently upheld by the courts. *Peoples Securities* v. *Securities and Exchange Commission*, 289 F. 2d 268 (C.A. 5, 1961); *Blaise d'Antoni* v. *Securities and Exchange Commission*, 289 F. 2d 276 (C.A. 5, 1961), certiorari denied, 368 U.S. 899 (1961).

For this reason it was not believed necessary to include the proposal in H.R. 6789.

H.R. 2480 would have permitted the Commission to postpone the effective date of a broker-dealer registration for a period of 90 days, rather than 15 days as now provided in the statute. H.R. 6789 includes a different approach to the same problem by strengthening the Commission's power to postpone the effective date of a broker-dealer registration pending final determination whether to deny registration, so as to dispense with the requirement of a formal oral hearing and permit the question to be disposed of on affidavits and oral argument, as is done by the courts in the similar case of a motion for preliminary injunction pending final decision. We believe that this approach will be more effective.

5. H.R. 2480 contained proposals based upon section 19(a)(4) which applies to exchange trading to prohibit trading in a security in the over-the-counter market for limited periods where the public interest and the protection of investors so require. A similar proposal is contained in section 6(c) of H.R. 6789.

6. H.R. 2480 contained proposals to clarify the Commission's authority to suspend a security from exchange trading where there has been a failure to comply with the act and where otherwise necessary in the public interest. This would have been accomplished by amending sections 19(a)(2) and 19(a)(4) of the act. Section 19(a)(2) empowers the Commission, after opportunity for hearing, to deny, suspend, or withdraw the registration of a security on a national exchange, but does not authorize the Commission to suspend trading in a security which still retains its registered status. The Commission's authority to suspend trading in a security registered on a national exchange is contained in section 19(a)(4) of the act, which permits, under stated circumstances, summary suspension of trading for a period not exceeding 10 days. During the pendency of proceedings under section 19(a)(2) to determine whether to deny, suspend, or withdraw the registration of a security on a national exchange the Commission has utilized its summary power under section 19(a)(4) to suspend trading in the security. In instances in which the section 19(a)(2) proceeding extended beyond the 10-day period, the Commission has issued a series of consecutive orders, each for a period of 10 days. This practice has required a redetermination every 10 days of the necessity of continuing the suspension under the standards in section 19(a)(4).

The proposal in H.R. 2480 would have eliminated the necessity of resorting to a series of successive 10-day suspensions while a proceeding under section 19(a)(2) was pending. The proposal to amend section 19(a)(4) would have codified the Commission's interpretation as to its powers under that section to enter a series of successive 10-day suspensions. Although these proposals would have reulted in some administrative convenience, it was not considered necessary to include them with the proposals in H.R. 6789.

7. H.R. 2480 would have authorized the Commission to suspend or withdraw the registration of a national securities exchange when the exchange had ceased to meet the requirements for original registration. No such proposal is included in H.R. 6789, since the Special Study suggested other, and less drastic methods of seeing to it that exchanges function properly.

8. H.R. 2480 contained provisions to implement the injunctive provisions of the act to make it clear that a showing of past violations is a sufficient basis for injunctive relief and that aiders and abettors may be responsible in civil and administrative proceedings. With respect to amendment of the injunctive provisions, it has been our experience in recent years that courts will not refuse to grant injunctions merely because the illegal activity has ceased. See, for example, *Securities and Exchange Commission* v. *Culpepper*, 270 F. 2d 241 (C.A. 2, 1959), which was decided 3 days before adjournment of the 86th Congress.

With respect to the proposals that aiders and abettors be made responsible in civil and administrative proceedings, the proposal in H.R. 6789 to amend section 15(b)(2) of the act, discussed above in paragraph 4, would make aiders and abettors liable in administrative proceedings.

9. H.R. 2480 contained proposals to provide that an insolvent broker or dealer may be adjudicated a bankrupt in an injunctive proceeding instituted by the Commission. Although the receiverships which the Commission has been successful in obtaining in many injunctive actions instituted by it have been administered under State receivership law rather than Federal bankruptcy law, they have generally worked out fairly satisfactorily from the standpoint of the protection of investors. However, the proposal in H.R. 2480 would have assured uniformity in the administration of the estates of insolvent broker-dealers. H.R. 6789 contains no such proposal, since it was believed that any such

recommendation should be held in abeyance while consideration is given to the desirability of proposing amendments to the Bankruptcy Act, as suggested by the Special Study.

10. H.R. 2480 contained a proposal to make embezzlement of moneys or securities entrusted to the care of an exchange member or registered broker or dealer a violation of the act. This proposal was directed to a highly technical matter; namely, the distinction between fraudulently obtaining customers' funds and embezzling or converting them. This distinction may depend upon whether the defendant had a wrongful intent at the time securities or funds were entrusted to him. It was not believed necessary to include such a highly technical proposal with those contained in H.R. 6789.

11. H.R. 2480 contained a proposal to provide for forfeiture of $100 for each day that any report required under the act is delinquent. No such proposal is contained in H.R. 6789. As stated in the testimony on November 20, this Commission does not believe it desirable that it be charged with the responsibility of collecting fines.

It should also be noted that the proposals in H.R. 6789 would repeal the existing provisions of section 32(b) of the act which provide for a fine of $100 a day for failure to file reports pursuant to an undertaking in a registration statement. It has been our experience that when an issuer fails to file such reports it is frequently insolvent, and, in any event, if the fine were to be collected it would result in penalizing the holders of the issuer's securities, the very persons the provision is designed to protect.

Mr. HARRIS. Earlier, I referred to a letter received from the president of the Richmond Stock Exchange, Richmond, Va. Apparently the matter has been taken up with the chairman of the Senate committee and there was some correspondence between Senator Robertson and the Commission.

I would like to include these letters in the record, if agreeable, and then ask the Commission when it has an opportunity to consider it and give us a little more information on it.

Mr. CARY. We shall be glad to, sir.

(The letter referred to follows:)

RICHMOND STOCK EXCHANGE,
Richmond, Va., November 15, 1963.

HON. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House Office Building, Washington, D.C.

DEAR MR. HARRIS: I understand that hearings begin before your committee next week on the Securities Acts Amendments of 1963 (S. 1642). There is one provision of the bill that may possibly damage the Richmond Stock Exchange. I cannot find any reason that satisfies me why this provision was included. I write to ask your consideration of amendment of the bill in this minor particular.

I enclose a copy of my letter of August 16, 1963, to the Honorable A. Willis Robertson discussing section 8(b) of the bill and of his reply of October 25, 1963, enclosing a letter dated October 7, 1963, from the Chairman of the Securities and Exchange Commission. The subject for discussion is the provision relating to inside trader profits and an exemption provided for certain securities dealers from the liabilities there provided in certain cases where they "make a market." The exemption is apparently made applicable in all cases except for trading upon an exempted exchange such as the Richmond Stock Exchange.

The reason for the exception is far from clear to me. Generally, members of the Richmond Stock Exchange "make the market" in the securities listed on the exchange, and the principal purpose of the exchange is to provide a setting for trading between members making a market and those who do not. If trading by controlling dealers is permitted off the exchange and prohibited on the exchange, the ability of the exchange to serve its members as a marketplace is potentially damaged. And Mr. Cary presents no evil that I can ascertain that the exception will cure.

As a matter of interest, I believe that Mr. Cary is in error on two points in his interpretation of the section. First, he says:

"The parenthetical phrase was included in section 8(b) of the bill to make certain that the market-maker exception to section 16(b) recovery would be

confined to over-the-counter trading as against trading on either a registered exchange or an exempted exchange."

But there is no provision that I can find that makes the exception inapplicable to trading on a national securities exchange; the exception is inapplicable only to trading on an exempted exchange. In a word, although it may be academic, the New York Stock Exchange seems to be favored over the Richmond Stock Exchange and for unexplained reasons.

Finally, Mr. Cary states that the Commission, in the case of exempted exchanges, "* * * could deal with these cases under its rulemaking powers." But the Commission cannot, under the guise of rulemaking, exempt what the statute in terms says shall not be exempt. It would be a false hope for my exchange to rely on any such possibility.

The reason for the parenthetical phrase in section 8(b) of the bill remains entirely obscure. Its inclusion may possibly damage the Richmond Stock Exchange. The bill should be amended, in my view, to eliminate the parenthetical phrase.

I realize that this may be a minor matter, but I cannot see this institution subject to potential damage unless I can understand why. If I can supply further information, please advise me and I will do my best to supply it.

JOHN K. B. RENNOLDS, *President.*

Enclosures.

RICHMOND STOCK EXCHANGE,
Richmond, Va., August 16, 1963.

Hon. A. WILLIS ROBERTSON,
Chairman, Committee on Banking and Currency,
Senate Office Building, Washington, D.C.

DEAR SENATOR ROBERTSON: The Securities Acts Amendments of 1963 (S. 1642) has, I believe, been passed by the Senate and sent on to the House. One provision of the bill is puzzling to me and I am unable to determine exactly what effect it will have on the Richmond Stock Exchange. It is for that reason that I seek your help by this letter.

The Richmond Stock Exchange is surely not one of the most active in the country, but it has had a long history and its members are convinced that it performs a useful, if limited, function in facilitating securities transactions in local issues in this community. The exchange is anxious to expand the number of issues listed on it and is apprehensive as to legislation that might, without sound basis, restrict its activities. By an order dated November 27, 1935, as amended by an order dated March 6, 1943, the Richmond Stock Exchange was exempted, on certain conditions, from the provisions of section 5 of the Securities Exchange Act of 1934.

Section 8(b) of the Securities Acts Amendments of 1963 as reported by the Senate Banking and Currency Committee provides as follows:

"(b) Section 16 of said Act is further amended by redesignating subsection (d) thereof as (e) and adding a new subsection (d) as follows:

"'(d) The provisions of subsection (b) of this section shall not apply to any purchase and sale, or sale and purchase, and the provisions of subsection (c) of this section shall not apply to any sale, of an equity security not then or theretofore held by him in an investment account, by a dealer in the ordinary course of his business and incident to the establishment or maintenance by him of a primary or secondary market (otherwise than on a national securities exchange exempted from registration, under section 5 of this title) for such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, define and prescribe terms and conditions with respect to securities held in an investment account and transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market.'"

The purpose of this section is obviously to relieve securities dealers who are also directors of issuers from the short-swing accounting provisions and the short sale prohibition of sections 16(b) and 16(c) of the Securities Exchange Act of 1934 with respect to securities of such issuers acquired and sold in connection with making a market. The reasons for this exemption are discussed in the Report of the Senate committee report (S. Rept. 379, pp. 21–23, 70) and in similar terms in the Statement of the Securities and Exchange Commission (CCH Federal Securities Law Reports, Special Report No. 905, pt. 1, June 20, 1963, pp.

92–95) and in its technical statement on S. 1642 (the same publication at pp. 142–143). The reasons are further discussed in a more detailed manner in the Report of Special Study of Securities Markets of the Securities and Exchange Commission (H. Doc. 95, pt. 3, 88th Cong., 1st sess., Apr. 3, 1963, pp. 42–55).

What bothers me is that none of this source material mentions the parenthetical clause in the section, that portion excepting transactions on a national securities exchange exempted from registration under section 5 of the act. Although I am not at all sure that I understand exactly what is intended by this parenthetical clause, it would appear that a dealer who was a director could not make a market in a security listed on an exempt exchange without being subject to the short-swing liability and the short sale prohibition.

In view of the limited market for issues listed on the Richmond Stock Exchange, such a proviison might well prove detrimental to it and might well inhibit the listing of additional issues on the exchange.

I wonder, therefore, if you could tell me whether the files of your committee contain any information that might make clear (a) whether the parenthetical phrase is intended to apply to issues listed on an exempt exchange or only to transactions consummated on an exempt exchange and (b) why the parenthetical phrase is included in the section. If I knew the intended scope of the phrase, the reasons for its inclusion and the evils that it was designed to prohibit, I could, I believe, much more easily determine its effect on the Richmond Stock Exchange.

I shall very deeply appreciate any information that you can supply me with regard to this matter.

Sincerely yours,

JOHN K. B. RENNOLDS, *President.*

U.S. SENATE,
COMMITTEE ON BANKING AND CURRENCY,
October 25, 1963.

JOHN K. B. RENNOLDS,
President, Richmond Stock Exchange,
Richmond, Va.

DEAR MR. RENNOLDS: In order to obtain the most authoritative answers possible to the questions raised in your letter of August 16, these questions were transmitted to the Securities and Exchange Commission. I now enclose a copy of the reply from Chairman Cary discussing the matter and setting forth the specific answers to your questions. I trust you will find all your questions resolved by Chairman Cary's letter.

Unfortunately, as Mr. Cary's note indicates, our request for comments on your letter was mislaid at the Commission, which explains the unfortunate delay.

As you no doubt know, the Senate has passed S. 1642, and it is now pending before the House Committee on Interstate and Foreign Commerce. Hearings have been scheduled beginning November 19.

With kind regards, I am

Sincerely yours,

A. WILLIS ROBERTSON, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., October 7, 1963.

MATTHEW HALE, Esq.,
Chief of Staff,
Committee on Banking and Currency,
U.S. Senate, Washington, D.C.

DEAR MATT: This is in reference to your memorandum of August 23, 1963, in which you request comments which would be helpful to Senator A. Willis Robertson in answering a letter he received from Mr. John K. B. Rennolds, president of the Richmond Stock Exchange, a copy of which was attached to your memorandum. In his letter Mr. Rennolds inquired as to the scope and purpose of the parenthetical clause which the Senate inserted in section 8(b) of S. 1642.

Section 8(b) of the bill would add a new subsection (d) to section 16 of the Securities Exchange Act of 1934, the effect of which would be to create a limited "market maker" exception to the provisions of section 16(b) of the Exchange Act. Section 16(b), as you know, permits recovery for the issuing corporation of any short-swing profit which an insider realizes from trading in equity securities which are subject to its provisions.

Even as expanded by the bill, the insider trading provisions of section 16(b) would still be limited to equity securities of companies which either (1) have a class of such securities listed on a national securities exchange, or (2) not having any class so listed, have 500 (initially 750) shareholders of a class of equity securities and $1 million in assets. To the extent that trading on exempted exchanges involved securities of any type except these two, the provisions concerning which Mr. Rennolds inquires, in fact all of section 16, would be wholly inapplicable.

Insider trading in equity securities of issuers which have a class of such securities listed on a national exchange has been subject to section 16(b) since 1934 without regard to where the trading occurred—it can even be directly between the parties rather than through any of the established market media. Thus, the only effect of the bill in this regard would be to bring insider trading in securities of the type last above described; i.e., the larger over-the-counter companies, within section 16(b), also regardless of where the trading occurred, except that dealers in the over-the-counter market, but not on exchanges whether registered or exempted, would have a limited marketmaker exemption as spelled out in section 8(b) of the bill.

On the basis of the foregoing, the answers to Mr. Rennolds' specific questions are:

(*a*) Whether an issue of securities is listed on an exempted exchange or merely traded there in a given transaction is not initially determinative of whether section 16(b) applies. Section 16(b) recovery depends upon the nature of the security itself, only the two types described above being subject to it.

(*b*) The parenthetical phrase was included in section 8(b) of the bill to make certain that the marketmaker exception to section 16(b) recovery would be confined to over-the-counter trading as against trading on either a registered exchange or an exempted exchange.

If experience should demonstrate that the limited exemption which section 8(b) would grant to marketmakers in the over-the-counter market should be extended in particular cases to like trading on the exempted exchanges, the Commission could deal with these in an appropriate manner under its rulemaking powers.

I trust that the foregoing comments will assist Senator Robertson in answering Mr. Rennolds' letter. However, if you should require any further comments, I will be happy to furnish them. I am sorry it has taken so long to answer your inquiry and I hope that no inconvenience has been caused by the delay.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Mr. CARY. I want to thank the committee very much for their cooperation and help, and I am sure that we can produce a piece of legislation of which we will be proud.

Thank you for your great help.

Mr. STAGGERS. Thank you.

(The following letters were later received from Mr. Cary:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 29, 1963.

Hon. OREN HARRIS,
House of Representatives,
Washington, D.C.

DEAR MR. HARRIS: In reviewing the transcript of my testimony before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce on Wednesday, November 20, 1963, I have noticed several points which I thought merited some clarification:

1. As appears on pages 262 and 263 of the transcript, you questioned me concerning the amount of manipulation now existing in the markets and whether it was the same as that in previous years. In answering this question, I may have created the erroneous impression that I was stating that there are as many manipulations and fraudulent transactions now as there were when the Special Study of Securities Markets was authorized. What I had wished to convey at that time was that our enforcement actions this year are as great as, if not greater than, in prior years. These actions, of course, often result from transactions which have occurred 2 or 3 years ago. At the same time, this in-

creased enforcement reflects our augmented staff and I believe an improvement in our procedures.

It is, of course, extremely difficult to provide any report on the extent of illegal activities in the markets as of a given moment. I have no reason to doubt that the situation on the American Stock Exchange has significantly improved and that the type of extensive manipulative activities apparent prior to the time the study was authorized is no longer evident. Furthermore, the Commission has no reason to believe that securities frauds are quite as prevalent as they were a few years ago.

2. As appears on pages 250 and following, you raised a series of important and significant questions about repeal of the intrastate exemption from registration for broker-dealers and the effect of section 28(a) of the Exchange Act. As you know, that section provides that nothing in the Exchange Act "shall affect the jurisdiction of the securities commission * * * of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder." It is that reserve clause which is the basis for State regulation of interstate broker-dealers who are presently registered with the Commission. As Mr. Loomis pointed out at the hearing, we can recall no instances in which there were conflicts between our jurisdiction over interstate broker-dealers and the jurisdiction of the States over these broker-dealers. Repeal of the intrastate exemption would place us in the same position with the intrastate broker-dealers as we are now in with the interstate broker-dealers; that is, the jurisdiction of the State securities authorities is reserved. Of course, the statute does state that State regulation cannot conflict with Federal. This would mean that a State authority could not relieve a broker-dealer from the duty to comply with Federal law and no State has ever attempted to do so. It does not mean, however, that States cannot require broker-dealers to comply both with their requirements and with Federal requirements and this they have done for 30 years. Thus, for example, if the Commission were to adopt a $5,000 minimum capital requirement, no State could specify that the brokers in its jurisdiction need have only $2,500 but any State could require, as a number do, $15,000. I would again emphasize that, although we have had this concurrent jurisdiction with the States for over 30 years with respect to interstate broker-dealers, I cannot recall any instance of conflict.

3. You mentioned Mr. Loomis' letter to Senator Robertson, dated July 17, 1963, in connection with the application of the over-the-counter disclosure provisions to farmers' cooperatives. I want to make clear that the Commission believes it highly unlikely that any farmers' cooperative will meet the test of H.R. 6789. If any cooperative does meet these tests, it is our intention to exempt it.

4. On page 227 of the transcript, I indicated that of the estimated 400 stock insurance companies to be covered by H.R. 6789, 171 were now filing reports with the Commission. In fact, the 171 figure represents the total number of insurance companies now filing reports with the Commission; two of these are listed companies and the remainder are subject to section 15(d). Of the 169 subject to section 15(d), probably 130 would meet the coverage test established by H.R. 6789 for registration of over-the-counter companies. Thus, I should like to have the figure 130 inserted in place of the figure 171 on pages 227 and 228. In addition, you made an arithmetical computation based on my erroneous figure which appears at page 228; here the number "292" should be changed to "about 270."

Faithfully yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 17, 1964.

Re Farmers' cooperatives.

Hon. OREN HARRIS,
House of Representatives,
Washington, D.C.

DEAR MR. HARRIS: In my letter of November 29, 1963, to you with respect to my testimony on November 20, I mentioned, among other things, the fact that the Commission believed it highly unlikely that any farmers' cooperatives will meet the test of H.R. 6789 and that, if any cooperative does meet these tests, it is our intention to exempt it.

Upon reflection I think it advisable to clarify this general reference to H.R. 6789 in view of the substantial number of legislative proposals contained in

that bill. What I had in mind was the application to farmers' cooperatives of the amendments contained in section 3(c) of the bill and related sections which would subject larger companies in the over-the-counter market to the reporting, proxy, and insider trading provisions of the Securities Exchange Act.

There are certain provisions of existing law which do apply to farmers' cooperatives. For example, if a farmers' cooperative makes an offer of securities to the public, as a few of the larger cooperatives have done, it is required to register under the Securities Act of 1933. Such registration may in turn subject the cooperative to reporting obligations under section 15(d) of the Securities Exchange Act of 1934, and I understand that four cooperatives are presently reporting pursuant to that section. I want to make it clear that my letter of November 29 did not refer to these requirements but rather to the new obligations which would be imposed upon the larger over-the-counter companies in respect of reporting, proxy solicitation, and insider trading.

Sincerely,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 21, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: During my testimony before you on Wednesday (November 20) you inquired as to our position on the applicability of the Securities Act of 1933 and the Investment Company Act of 1940 to the offering of public participations in units of interest in so-called commingled or common funds operated by banks. In that connection Congressman Keith observed that the Senate Committee on Appropriations inserted restrictive language on this subject matter in its report on that part of the independent offices appropriations, 1964, bill (H.R. 8747) relating to this Commission's appropriation. The text of the restrictive language to which Mr. Keith referred is as follows:

"The committee notes the conflict of asserted jurisdiction in the field of administration of common trust funds. It is our opinion that national banks are adequately supervised by the Comptroller of the Currency, and directs that no funds appropriated in this bill be expended by the SEC for that purpose."

Perhaps you are aware that Senator Anderson expressed his displeasure at this technique on the Senate floor Tuesday describing it as "a new method of putting legislation into an appropriation bill in such fashion that it cannot be attacked by either House" (vol. 109, Congressional Record, No. 187, Nov. 19, 1963, p. 21273). In response to Senator Magnuson's statement that the agency could ignore what the committee says in its report, Senator Anderson said "But the agency would have its head chopped off when its representatives appeared before the Appropriations Committee at the next session * * *" (ibid).

Much more of a controversy developed on the same subject on the Senate floor yesterday between Senators Allott and Magnuson, on the one hand, and Senators Humphrey, Javits, Robertson, and Williams, on the other, the latter expressing their concern. If you haven't already, perhaps you would be interested in reading this rather extensive colloquy in volume 109, Congressional Record, No. 188, November 20, 1963, pages 21333–21338.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 27, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Further with reference to my letter of November 21 concerning the restrictive language in the report of the Senate Committee on Appropriations with respect to our activities relating to the proposed offering by banks of units of interest in commingled funds, Senator Robertson last week asked us for a letter outlining our views on this subject. Such a letter was prepared today and I am enclosing a copy for your information.

Faithfully yours,

WILLIAM L. CARY, *Chairman.*

NOVEMBER 27, 1963.

Hon. A. WILLIS ROBERTSON,
U.S. Senate, Washington, D.C.

DEAR SENATOR ROBERTSON: This is in response to your request by telephone Friday for an expression of our views as to the applicability of the Federal securities laws to the proposed offering to the public of units of interest in common or commingled funds operated by banks.

Unlike the bank depositor who has the absolute right to receive the fixed amount he has deposited, the investor in the bank commingled fund will buy a pro rata share of a pool of largely equity securities, and the value of his investment will fluctuate in accordance with the market performance of the pooled portfolio. To us this is indistinguishable from the purchase of a share in a mutual fund. The only difference is one without substance or significance to our responsibility for investor protection—namely, that a bank will sponsor and manage the mutual fund rather than an investment banker, investment adviser, insurance company, or some other organization. Accordingly, we have taken the position that the units of interest in the commingled fund must be registered under the Securities Act of 1933 and the fund itself registered under the Investment Company Act of 1940.

In the past the commingled fund activities of banks have been severely limited. The Federal Reserve Board was particularly sensitive to the problem of the banks entering the securities business, and during the more than 25 years that it had jurisdiction over bank commingled fund activities the Board restricted the use of bank common trust funds to trusts set up for "bona fide fiduciary purposes." The Board explained in the May 1940 issue of the Federla Reserve Bulletin that the purpose of this prohibition was "that trust guise or form should not be used to enable a trust institution to operate a common trust fund as an investment trust attracting money seeking investment alone and to embark upon what would be in effect the sale of participations in a common trust fund to the public as investments * * *." Such strictly limited common trust funds were exempted by the Congress from the Investment Company Act, by section 3(c)(3) of that act. When, as happened in a few instances, a bank overstepped the boundaries set out by the Federal Reserve Board by advertising the availability of its common trust fund as an investment medium the Commission took the position that the bank was operating an unregistered investment company in violation of the provisions of the Investment Company Act. In addition, the Federal Reserve Board warned the bank to cease engaging in the activity.

However, banks continually sought to expand the scope of permissible activity of common trust funds. These attempts were stepped up in the late 1950's as banks watched the spectacular growth of the mutual fund industry and looked for a way to capture some of the market for themselves. The Federal Reserve Board consistently resisted this attempt to enlarge the scope of common trust fund activity—in December 1960 even proposing to narrow the definition of the type of trust whose assets could be commingled in the common trust fund. The struggle between the banks and the Federal Reserve Board was described in an article which appeared in the November 1962 issue of Trusts and Estates by Joseph H. Wolfe, a vice president of the New England Merchants National Bank. (Mr. Wolfe was a member of the committee later appointed by the Comptroller of the Currency to assist him in drafting regulation 9.) Mr. Wolfe wrote:

"The memory of the bank holiday era was too fresh in the minds of the Board of Governors for them to promulgate rules and regulations that would really be effective for the type of service the banks needed to offer * * * A long struggle began on the part of trustmen to obtain a more liberal set of rules and regulations, with the administrative staff of the Board seeking to maintain the status quo. Trustmen wanted to explain and enlarge the theory of the common trust fund and to use the fund whenever it seemed appropriate in a growing market.

* * * * * * *

"*One of the great fears in the minds of the Board was that trust departments would broaden the original scope and would be in a position to compete with savings departments and investment trusts.* This feeling was so strong that the authors of the Trust Division's Common Trust Fund Handbook, second edition, published in 1948, gave the following warning to trustmen:

" 'This emphasizes and clarifies the extent to which the Board of Governors of the Federal Reserve System insists that a trust institution must go to avoid

even the appearance of offering a common trust fund to the public as an investment.'" (Italic added.)

In late 1962 two events occurred which were to lead to the presently contemplated expansion of bank commingled fund activity. Passage of the Self-Employed Individuals Tax Retirement Act of 1962 (the Smathers-Keogh bill) offered the opportunity of expanded activity by banks as well as others in the retirement plan area.

In addition, in September 1962 authority with respect to bank commingled funds including common trust funds was transferred from the Federal Reserve Board to the Comptroller of the Currency. In April 1963 the Comptroller issued new rules governing commingled funds in his revised regulation 9, which deleted the "bona fide fiduciary purpose" test that the Federal Reserve Board had used as a bulwark to keep the banks out of the mutual fund business and to limit their activities to traditional trust business. While the banks have traditionally provided investment advice for large individual accounts (which they call managing agency accounts) just as have investment counselor firms, regulation 9 for the first time permitted the commingling of managing agency accounts, which would allow the banks to handle large numbers of smaller investment accounts on a pooled basis. When the investment counselor firm provides advice on such a pooled basis, the pool is known as a mutual fund and is subject to the Investment Company Act.

It is interesting to note that bankers themselves have, in discussing the need from the bank's point of view for expanding the permissible scope of common trust fund activity, been well aware that they were entering the securities business. For example, when the Chairman of the Committee which assisted the Comptroller in drafting regulation 9, Reese H. Harris, Jr., executive vice president of Manufacturers Hanover Trust Company, New York, urged at the mid-winter trust conference of the American Bankers Association in 1962 that the banks be given the powers which were eventually accorded to them by regulation 9, he concluded by saying:

"However, I believe we should be privileged to pool the investments of all sizes of managing agencies because collective investing is the best way to invest customers' funds in most cases. I realize that *this probably means operating open-end investment trusts* for selected customers, and perhaps eventually for the public. I am willing to accept this to permit us to take care of the needs of our existing customers and, in addition, serve others who may never enter the doors of our trust departments if we do not have a service that appeals to them as they accumulate an estate." (Italic added.)

The interests in bank commingled funds which would be used for Smathers-Keogh retirement plans fall within the definition of a security contained in section 2 of the Securities Act. For such activity to be profitable to the banks the interests in such funds would, as bankers themselves have admitted, have to be widely merchandized to large numbers of people. Such public offerings would be subject to the registration and disclosure provisions of the Securities Act. They would, however, be exempt from the Investment Company Act, by section 3(c)(13) of that act as are other pension or profit-sharing plans qualified under section 401 of the Internal Revenue Code. The principles involved with respect to the applicability of the securities laws to the merchandising of bank sponsored Smathers-Keogh commingled funds are the same as those applicable when insurance companies offer interests in commingled funds for Smathers-Keogh plans, and when professional and other associations set up commingled Smathers-Keogh funds for their members. I might mention that the Prudential Insurance Co. of America has informed us that it plans shortly to file a Securities Act registration statement for its Smathers-Keogh plan; and several associations, including the American Bar Association and American Medical Association, have filed registration statements with us for their plans—which, incidentally, are to be trusteed by major banks. None of these registrants is contesting the applicability of the Securities Act.

With respect to bank commingled managing agency accounts, the banks, as pointed out above, are in effect now proposing to do precisely what the investment counselor did in the late 1920's and 1930's and what Congress in 1940 determined to be a mutual fund subject to the Investment Company Act. We have taken the position that both the Securities Act and the Investment Company Act would apply to such activities. The problem is the same as that presented by the variable annuity sold by the insurance industry, which the Supreme Court in 1959 determined fell within the scope of the Securities Act and the Investment Company Act. *S.E.C.* v. *Variable Annuity Life Insurance Co. of America*, 359 U.S. 65.

The Commission believes not only that the securities laws clearly apply to the contemplated expansion of bank commingled fund activities but that such applicability is necessary and appropriate. Investors in bank sponsored investment funds are entitled to the same protections as investors in funds sponsored by any other organization—whether a broker, investment counselor, insurance company, or other persons.

Some attack the necessity of applying the Federal securities laws on the ground that banks are presently thoroughly regulated and that investors are, therefore, furnished adequate protection. On the surface some might find this persuasive, but the reality is that this argument entirely misconceives the nature, purpose, and thrust of bank regulation as distinguished from securities regulation. Bank regulation has the objectives of controlling the flow of credit in the monetary system, the maintenance of an effective banking structure and the protection of depositors. These do not provide investor protection. Investor protection is the precise focus of the Federal securities laws. I should add that the rationale of the bank regulation argument is not new. A comparable argument was repeatedly asserted as to insurance regulation by insurance companies who resisted the application of the securities laws to variable annuity programs. The Supreme Court rejected this argument in the *Variable Annuity Life Insurance* case mentioned above, and the concurring opinion of Mr. Justice Brennan contains an excellent analysis of the differences in securities and insurance regulation and concludes that the latter is inadequate for investor protection.

The banking industry seeks to avoid the application of the securities laws to their proposed activities. Consequently, the American Bankers Association was instrumental in having introduced S. 2223, the so-called Bank Collective Fund Act of 1963, which has been referred to your committee. The Commission is opposed to this bill.

The bill would provide a separate standard of regulation for collective investment funds maintained by banks—a standard specifically designed to replace that created by the securities laws. The bill would achieve this result by exempting interests in collective investment funds, as defined in section 2(c) of the bill, from the definition of a security in the Securities Act and the Securities Exchange Act and by exempting the funds themselves from the definition of investment company in the Investment Company Act.

This technique underscores the fundamental criticism which the Commission has of the bill. The bill says, in effect, that even though a bank merchandizes interests in one of its collective investment funds to the public, it has not entered the securities business. It is the Commission's position that the bank has, at that point, entered the securities business, and that the same rules for investor protection should, at that point, be applicable to the bank as are applicable to other persons in the securities business. The emphasis of the Congress and the Commission over the last 30 years has been on the development of uniform rules for the protection of all investors. No purpose seems to be served by enacting special legislation for the protection of investors whose contact with the securities business is through banks merely because the banks have decided that the securities business is a profitable one in which to engage.

One reason that the bill has been drafted to deny that banks have entered the securities business in certain of their commingled fund activity apparently is to avoid any problems which might be raised under those portions of the Glass-Steagall Act which prohibit commercial banks from engaging in such business. To the extent that such problems exist, Congress will no doubt wish to deal with them directly. They should not be disposed of by a drafting technique—particularly when such technique would entail the loss of important safeguards for investors.

The standards which the bill would supply in place of those in the securities laws are meager and inadequate. For one thing, although as pointed out above bank commingled managing agency accounts are in substance only bank-sponsored mutual funds, the bill would provide none of the many regulatory provisions and protections which the Congress through the Investment Company Act has specifically accorded to investors in mutual funds. The Investment Company Act is a complex 47 page statute and I shall not attempt to list all the provisions here, but among the more important ones are: prohibition against changes of a fund's investment policy without the consent of the shareholders or investors; limitations on the borrowing powers of funds and their ability to purchase securities on margin; prohibitions against advisory contracts being binding obligations of the funds for long periods of time; prohibitions against assignments of advisory contracts without the consent of the shareholders or

investors; limitations on joint activities by the fund with affiliated persons and of transactions between the fund and affiliated persons; requirements that the shareholders or investors be allowed to vote for directors for the fund and that a portion of the board of directors consist of persons not affiliated with the adviser or sponsor; and limitations on the extent to which the governing documents of the fund may contain provisions exculpating management personnel from liability.

The bill also provides inadequate substitutes for the disclosure requirements which apply to commingled funds under the securities laws. The securities laws require that full information concerning the fund be disclosed to prospective investors in a form which would permit them to make an intelligent investment choice. In addition they require the periodic reporting of information to investors which permits them to judge how well their investment is being managed.

Let me cite just a few of the important failures of the bill to provide adequate disclosures of these kinds. The banks may solicit investments in collective investment funds by using sales literature unaccompanied by anything in the nature of a prospectus. The prospectus itself as contemplated by the bill can consist of a "plan" (which may be a complex legal document) and a copy of the financial report of the fund for the latest year. As a consequence the investor is not told what his rights in the fund are in an intelligible form. The material the investor receives is not required to make disclosures with respect to matters as fundamental as who the persons are who will perform the advisory function for the fund (which may not be the bank) or the investment performance of the fund. Nor need periodic reports be sent to investors. Further, the bill does not provide the civil remedies for investors which are contained in the securities laws.

Finally, the bill contemplates that it would be administered by the three Federal banking agencies. While we do not object to the concept of a portion of securities regulation being administered, under certain circumstances, by other agencies, we do feel that with respect to the full range of regulatory and disclosure provisions which Congress has provided in the securities laws for mutual fund activities, governmental efficiency and uniformity of treatment would be served by having them administered by only one agency.

In short, our position is that the situation of all investors in commingled funds is the same whether the sponsor or the adviser is a bank, a private investment counselor, a broker dealer, an insurance company, or some other person. Consequently, all these investors are entitled to the same protections. No purpose would seem to be served by enacting special legislation, let alone inadequate or discriminatory legislation, each time a new industry decides that the securities and commingled fund business is a profitable one in which to engage. Hence we are opposed to the so-called Bank Collective Fund Act of 1963.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

Mr. STAGGERS. Mr. Funston?

Welcome to the committee, Mr. Funston. We are glad to have you. I am sorry you had to wait so long. I believe you can understand, in your position, the importance of what we are trying to do here.

We are certainly glad that you can come and help us in our job.

If you will, identify yourself and proceed.

STATEMENT OF G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE; ACCOMPANIED BY EDWARD C. GRAY, EXECUTIVE VICE PRESIDENT, NEW YORK STOCK EXCHANGE; AND SAMUEL L. ROSENBERRY, OF MILBANK, TWEED, HADLEY & McCLOY, COUNSEL TO NEW YORK STOCK EXCHANGE

Mr. FUNSTON. Thank you, Mr. Chairman.

My name is G. Keith Funston. I am president of the New York Stock Exchange. With me today are Edward C. Gray, executive vice president of the exchange, and Samuel L. Rosenberry of Milbank, Tweed, Hadley & McCloy, counsel to the exchange.

We appreciate having the opportunity today to present the exchange's view on H.R. 6789, H.R. 6793 and S. 1642. Furthermore, pursuant to the committee chairman's request in a letter of October 16, 1963, we have filed a statement with the committee analyzing the adequacy, for the protection of investors, of the exchange's rules. This statement reflects comments by the exchange on the views expressed by the Special Study of the Securities Markets and by the Securities and Exchange Commission in its letters of transmittal to the Congress.

H.R. 6789, H.R. 6793, AND S. 1642

First, I would like to briefly state the New York Stock Exchange's position on identical bills H.R. 6789 and H.R. 6793. In my testimony before the Senate Finance Committee (attached as exhibit A), we supported the Senate counterpart bill without reservation. We support without reservation this bill S. 1642 as amended and passed by the Senate.

ADEQUATE DISCLOSURE

For over 20 years, the exchanage has favored legislation to extend the disclosures and reporting requirements of the Securities Exchange Act of 1934 to all publicly held companies. Full disclosure—a cornerstone of the Securities Acts—is weakened by the illogical double standard under which publicly held listed companies are not legally required to give their shareowners the information and benefits that Congress prescribed for shareowners in listed companies as long ago as 1934. The present bill would go a long way toward providing equal protection for all investors and we urge that it be enacted without delay.

SELF-REGULATION

The 1934 act adopted self-regulation as a basic concept. The premise of that legislation was that the national securities exchanges would regulate themselves, subject to oversight by the Securities and Exchange Commission of the efficacy of self-regulation in certain areas spelled out in section 19(b) of the 1934 act.

This concept was extended by the Maloney Act amendment to the 1934 act, section 15A, with a somewhat different pattern. Under this pattern, the SEC reviews disciplinary actions of the National Association of Securities Dealers as well as any rule changes.

The endorsement of self-regulation which appears in the Report of the Special Study of the Securities Markets and in the Commission's letters of transmittal to Congress, is particularly encouraging. The legislation before you today would improve the present system by helping to close several gaps in the basic regulatory pattern. It would strengthen the self-regulatory role of the National Association of Securities Dealers by empowering that association to establish such minimum capital requirements and appropriate standards with respect to training, experience and other qualification as that association may find necessary or desirable in order to set standards for individuals and firms dealing with the investing public.

This added authority, in conjunction with the requirement in the bill that all broker-dealers must be subject to the self-regulatory authority of an appropriate securities association, would give an important new dimension to the industry's overall self-regulatory pattern.

SEC DISCIPLINARY CONTROLS

Another important effect of the proposed legislation would be to place the Securities and Exchange Commission's direct disciplinary authority over firms and individuals on a sounder basis. In the enforcement of the securities laws, the Securities and Exchange Commission has operated under a dual handicap; that is, it has lacked the authority to impose intermediate sanctions short of broker-dealer revocation, and second, the authority to proceed directly against an individual violator except through action against his firm. Hence, the SEC has had to choose between permitting less serious violations to go unpunished and invoking overly harsh penalties that affect the innocent as well as the guilty.

The bills before you would strengthen the Commission's disciplinary controls by empowering it to proceed directly against an individual who has violated the securities laws and to impose the intermediate sanctions of censure or suspension in appropriate instances.

To recapitulate, the exchange urges enactment of this legislation because it would close major gaps in corporate disclosure requirements, the industry's basic self-regulatory pattern and the Commission's direct disciplinary authority over firms and individuals.

SPECIAL STUDY OF THE SECURITIES MARKETS

The Special Study of the Securities Markets was authorized when Congress enacted the House Joint Resolution on September 5, 1961. The study continued over the succeeding 23 months, culminating on August 8 of this year in the transmittal of the final section of the report to the Congress.

Naturally, a study of this bulk could not be fully and objectively evaluated during the relatively short period of time since it was made available to the industry and the investing public. However, the exchange has devoted a significant amount of time and effort over the past 3 months to reviewing some 176 recommendations which directly affect our organization. On October 18, 1963, I sent a letter to our membership explaining the steps already taken in connection with possible exchange responses to these recommendations. A copy of that letter is attached, as exhibit B.

The responsibility for making whatever policy decisions may stem from our review of the Special Study Report lies not with the exchange staff, but with the 33-man board of governors. To evaluate the recommendations of the study group more efficiently and promptly, the board has appointed five special committees to review the major recommendations. Included in exhibit B is a list of these committees and some of the more important recommendations that have been assigned to them.

The exchange has also engaged consultants to assist the board in arriving at determinations in three key areas. The names of the consultants are identified and their particular subjects for study are also indicated in exhibit B.

The size and the scope of the study make it obvious that much work remains to be done before final determinations can be reached on most of the recommendations affecting the exchange and its delicate mechanism, the auction market. The views of our membership have been

solicited by the board to assist the committees and the board in their deliberations. Obviously, in many areas, discussions must be held with the SEC before the board arrives at a determination. Though the task is enormous—especially when it is realized that we cannot divert all of our energies from the day-to-day task of running the exchange—I want to assure this committee that the job will be pursued thoroughly and promptly. Where action is deemed desirable in the interest of the investing public, it will be taken.

In my letter to the exchange membership, I commented that it was no surprise to the exchange community that the Special Study Group found no pattern of fraudulent activity involving our organization. And while the report is critical of some specific details of exchange operations, in general it does not challenge in any basic respect the exchange's stewardship of the marketplace. Equally significant to the entire securities industry is the strong reaffirmation of the self-regulation which appears conspicuously throughout the report.

We recognize that a fresh perspective can often be obtained from a study conducted by people outside the exchange community. Our analysis of the Special Study's recommendations is proceeding with this thought in mind. Although it would be inappropriate for me to comment on the Special Study's recommendations before our board of governors has completed its deliberations, I would like to offer some general comments on various aspects of the report.

The first of these involves the question of floor trading. This was mentioned early in the discussion this afternoon. As you know, the Commission agreed with the Study Group's suggestion that it should be abolished unless the exchanges can demonstrate the need for its continuance. The essence of a securities auction market is the gathering together of all buy and sell orders in one place at a given time—so that a fair auction can occur, enabling buyers and sellers to receive the best price possible at that moment. The flow of orders to one central place from the various segments of the investment community—the public investor, the institutional investor, and the professional investor—all combine to provide the market liquidity that is so essential. The more liquid the market, the more able it is to serve the investing public.

Any recommendation to limit or eliminate an important source element of supply or demand must be carefully weighed in the light of its potentially harmful effect on liquidity as well as the benefit to be gained.

No one would dispute, I think, that floor trading contributes to market liquidity. The Study Group appears to recommend that it be abolished in spite of that important factor. The Commission, in accepting that recommendation, stated in its letter of July 23, 1963, to the Congress that "* * * the Commission agrees that a rule proposal abolishing floor trading on the New York and American Stock Exchanges should be developed, unless those exchanges demonstrate that its continuance would be consistent with the public interest." The exchange has accepted the Commission's invitation and has requested an opportunity to discuss this subject with the Commission as soon as the Board of Governors has completed its analysis of floor trading, in the light of the studies by an outside consultant retained by the Board and of other relevant information.

A second recommendation we view with concern involves off-board trading in listed securities (the so-called third market) and dual trading of listed securities on the New York Stock Exchange and one or more regional exchanges. These practices have been accepted and encouraged both by the Special Study Group and by the Commission in its letters of transmittal to Congress. Here again it is essential to recognize that diverting buy and sell orders from the primary market detracts from the liquidity of that market. We are particularly disturbed by the Commission's ready acceptance of the third market as a healthy influence.

No one questions that competition is an essential element of our free enterprise system. However, competition should be on an equal basis and competitors should be subject to similar restraints and controls. It is difficult to understand the logic that encourages a dilution of the primary market by the third market without subjecting the latter to the same regulatory controls imposed on the former. Surely, the investor, entering either market should be entitled to such safeguards as the public disclosure of price and volume information, the restrictions on short sales, the regulations governing dealers and traders in an exchange market, and the requirements that a fair and orderly market be maintained at all times.

The third market operates under the umbrella of the exchange's auction market, often gearing transactions to prices in our market. In times of crisis, however, over-the-counter dealers in listed securities are presently free to step away from the market or even use the exchange as a convenient dumping ground. And while there are many recommendations in the report which, if adopted, would affect the over-the-counter dealers in listed stocks, the overriding consideration—here as elsewhere—should be to maintain the highest possible degree liquidity in the primary market. The continuing health and responsivenes of the primary market are by no means accidental or automatic. Its liquidity, its ability to provide tight markets in individual securities, to absorb or supply large blocks of stock, and to keep price changes within extremely narrow ranges, all depend upon the maximum accumulation—in the central marketplace—of orders from institutions and individuals alike. I believe it is abundantly clear that the problems which must be dealt with in this area are particularly complex. They involve not only degrees of regulation and responsibilities to the market, but rates of commission and dealer profits—among many other considerations.

The exchange welcomes the opportunity to study these problems internally and we look forward to discussing them in detail with the Commission and other interested parties in the months ahead.

A third general comment I would offer is that the Study Group's recommendations must be examined not only on an individual basis, but also as to their total impact on the entire securities industry. To put into effect and to enforce all of the recommendations would call for a significant expenditure of manpower and money. The industry's ability to bear such expense should by no means be taken for granted. It is true that in the specific years prior to 1962 covered by the report, the industry as a whole presented a reasonably healthy profit picture. A healthy industry is essential if the Nation's investors are to be served adequately and the Nation's industry is to obtain the capital necessary for expansion and modernization of its productive capacities.

It is also true that 1962 was not a very profitable year for the securities industry. The exchange, with the approval of the SEC, has developed an income and expense survey which is designed to show the profitability of the commission business for our member firms from all sources—New York Exchange, American Exchange, regional exchanges, and agency transactions over the counter. The 1962 survey included 365 of our member firms, accounting for approximately 85 percent of all NYSE commission business during the year. The results indicate that in 1962 the average net profit of member organizations' commission business, after taxes, was four-tenths of 1 percent—with more than half of our member organizations showing losses. This, combined with a sharp decline in underwriting in 1962, presents a very unsatisfactory profit picture on which to superimpose the additional burdens that would result from indiscriminate adoption of the study group's recommendations.

I do not mean to suggest that action should not be taken promptly where its need has been clearly demonstrated. But I do mean that the efficient operation of an industry should not be stifled by restrictions designed to avoid or to eliminate an occasional situation. Neither governmental regulation nor self-regulation can hope to protect the imprudent investor against himself. I think it is extremely important that a point-by-point approach should not ignore the overall impact on the industry, and that any change should be based on clear evidence of its necessity. Each change must be both feasible and economically practical if, in the long run, the securities industry is to continue to serve the investing public.

CONCLUSION

In conclusion, I would like to return for a moment to the subject of self-regulation. The Special Study and the resulting legislative proposals reaffirm the wisdom of Congress in establishing industry self-regulation as a practical and effective method of providing investor protection. Nevertheless, a number of the study group recommendations call for Commission action in areas where the self-regulatory bodies themselves could act.

If self-regulation is to continue in the pattern established by Congress, then the basic responsibility of the self-regulatory bodies to adopt, revise, and enforce their own rules must be maintained.

We would like again to make the point that the exchange already has rules in many of the areas in which the study group recommends that the Commission adopt rules of its own. The Commission should act only when the self-regulators fail to make such changes, or when action is necessary in areas where the Commission has sole jurisdiction. The practical application of the concept of industry self-regulation with Government oversight requires the striking of a delicate balance in which Government should not become involved in the day-to-day self-regulatory operations. The proper role of Government is to determine the effectiveness of self-regulation by reviewing patterns and practices, leaving the daily regulatory job in the hands of the self-regulatory bodies. We believe that this was the relationship envisioned by Congress when passing the Securities Exchange Act, that the philosophy has been proved in practice over the years, and should

be encouraged to continue its further development rather than to be curtailed.

We sincerely hope that, in accordance with this concept, implementation of any of the recommendations now under study will be sought where possible through the exchanges and the NASD.

In closing, I want to urge once again the passage of the proposed legislation before you.

Thank you, Mr. Chairman.

(Mr. Funston's extended statement follows:)

STATEMENT OF G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE, ON H.R. 6789, H.R. 6793, AND S. 1642 BEFORE THE SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE HOUSE INTERSTATE AND FOREIGN COMMERCE COMMITTEE, NOVEMBER 20, 1963

My name is G. Keith Funston. I am president of the New York Stock Exchange. With me today are Edward C. Gray, executive vice president of the exchange, and Samuel L. Rosenberry of Milbank, Tweed, Hadley & McCloy, counsel to the exchange.

We appreciate having the opportunity today to present the exchange's views on H.R. 6789, H.R. 6793, and S. 1642. Furthermore, pursuant to the committee chairman's request in a letter of October 16, 1963, we have filed a statement with the committee analyzing the adequacy, for the protection of investors, of the exchange's rules. This statement reflects comments by the exchange on the views expressed by the Special Study of the Securities Markets and by the Securities and Exchange Commission in its letters of transmittal to the Congress.

H.R. 6789, H.R. 6793, AND S. 1642

First, I would like to briefly state the New York Stock Exchange's position on identical bills H.R. 6789 and H.R. 6793. In my testimony before the Senate Finance Committee (attached as exhibit A), we supported the Senate counterpart bill without reservation. We support, without reservation, this bill, S. 1642, as amended and passed by the Senate.

ADEQUATE DISCLOSURE

For over 20 years, the exchange has favored legislation to extend the disclosure and reporting requirements of the Securities Exchange Act of 1934 to all publicly held companies. Full disclosure—a cornerstone of the Securities Acts—is weakened by the illogical double standard under which publicly held unlisted companies are not legally required to give their shareowners the information and benefits that Congress prescribed for shareowners in listed companies as long ago as 1934. The present bill would go a long way toward providing equal protection for all investors and we urge that it be enacted without delay.

SELF-REGULATION

The 1934 act adopted self-regulation as a basic concept. The premise of that legislation was that the national securities exchanges would regulate themselves, subject to oversight by the Securities and Exchange Commission of the efficacy of self-regulation in certain areas spelled out in Section 19(b) of the 1934 Act.

This concept was extended by the Maloney Act amendment to the 1934 act, section 15A, with a somewhat different pattern. Under this pattern, the SEC reviews disciplinary actions of the National Association of Securities Dealers as well as any rule changes.

The endorsement of self-regulation, which appears in the report of the Special Study of the Securities Markets and in the Commission's letters of transmittal to Congress, is particularly encouraging. The legislation before you today would improve the present system by helping to close several gaps in the basic regulatory pattern. It would strengthen the self-regulatory role of the National Association of Securities Dealers by empowering that association to establish such minimum capital requirements and appropriate standards with respect to training, experience, and other qualifications as that association may find necessary or desirable in order to set standards for individuals and firms dealing with the investing public.

This added authority, in conjunction with the requirement in the bill that all broker-dealers must be subject to the self-regulatory authority of an appropriate securities association, would give an important new dimension to the industry's overall self-regulatory pattern.

SEC DISCIPLINARY CONTROLS

Another important effect of the proposed legislation would be to place the Securities and Exchange Commission's direct disciplinary authority over firms and individuals on a sounder basis. In the enforcement of the securities laws, the Securities and Exchange Commission has operated under a dual handicap; that is, it has lacked first the authority to impose intermediate sanctions short of broker-dealer revocation and second the authority to proceed directly against an individual violator except through action against his firm. Hence, the SEC has had to choose between permitting less serious violations to go unpunished and invoking overly harsh penalties that affect the innocent as well as the guilty.

The bills before you would strengthen the Commission's disciplinary controls by empowering it to proceed directly against an individual who has violated the securities laws and to impose the intermediate sanctions of censure or suspension in appropriate instances.

To recapitulate, the exchange urges enactment of this legislation because it would close major gaps in corporate disclosure requirements, the industry's basic self-regulatory pattern, and the Commission's direct disciplinary authority over firms and individuals.

SPECIAL STUDY OF THE SECURITIES MARKETS

The Special Study of the Securities Markets was authorized when Congress enacted the House Joint Resolution on September 5, 1961. The study continued over the succeeding 23 months, culminating on August 8 of this year in the transmittal of the final section of the report to the Congress.

Naturally, a study of this bulk could not be fully and objectively evaluated during the relatively short period of time since it was made available to the industry and the investing public. However, the exchange has devoted a significant amount of time and effort over the past 3 months to reviewing some 176 recommendations which directly affect our organization. On October 18, 1963, I sent a letter to our membership explaining the steps already taken in connection with possible exchange responses to these recommendations. A copy of that letter is attached, as exhibit B.

The responsibility for making whatever policy decisions may stem from our review of the Special Study Report lies not with the exchange staff, but with the 33-man board of governors. To evaluate the recommendations of the study group more efficiently and promptly, the board has appointed five special committees to review the major recommendations. Included in exhibit B is a list of these committees and some of the more important recommendations that have been assigned to them.

The exchange has also engaged consultants to assist the board in arriving at determinations in three key areas. The names of the consultants are indentified and their particular subjects for study are also indicated in exhibit B.

The size and scope of the study make it obvious that much work remains to be done before final determinations can be reached on most of the recommendations affecting the exchange and its delicate mechanism, the auction market. The views of our membership have been solicited by the board to assist the special committees and the board in their deliberations. Obviously, in many areas, discussions must be held with the SEC before the board arrives at a determination. Though the task is enormous—especially when it is realized that we cannot divert all of our energies from the day-to-day task of running the exchange—I want to assure this committee that the job will be pursued thoroughly and promptly. Where action is deemed desirable in the interest of the investing public, it will be taken.

In my letter to the exchange membership, I commented that it was no surprise to the exchange community that the Special Study Group found no pattern of fradulent activity involving our organization. And while the report is critical of some specific details of exchange operations, in general it does not challenge in any basic respect the exchange's stewardship of the marketplace. Equally significant to the entire securities industry is the strong reaffirmation of self-regulation which appears conspicuously throughout the report.

We recognize that a fresh perspective can often be obtained from a study conducted by people outside the exchange community. Our analysis of the Special Study's recommendations is proceeding with this thought in mind. Although it would be inappropriate for me to comment on the Special Study's recommendations before our board of governors has completed its deliberations, I would like to offer some general comments on various aspects of the report.

The first of these involves the question of floor trading. As you know, the Commission agreed with the Study Group's suggestion that it should be abolished unless the exchanges can demonstrate the need for its continuance. The essence of a securities auction market is the gathering together of all buy-and-sell orders in one place at a given time—so that a fair auction can occur, enabling buyers and sellers to receive the best price possible at that moment. The flow of orders to one central place from the various segments of the investment community—the public investor, the institutional investor, and the professional investor—all combine to provide the market liquidity that is so essential. The more liquid the market, the more able it is to serve the investing public.

Any recommendation to limit or eliminate an important element of supply or demand must be carefully weighted in the light of its potentially harmful effect on liquidity as well as the benefit to be gained.

No one would dispute, I think, that floor trading contributes to market liquidity. The Study Group appears to recommend that it be abolished in spite of that important factor. The Commission, in accepting that recommendation, stated in its letter of July 23, 1963, to the Congress that "* * * the Commission agrees that a rule proposal abolishing floor trading on the New York and American Stock Exchanges should be developed, unless those exchanges demonstrate that its continuance would be consistent with the public interest." The exchange has accepted the Commission's invitation and has requested an opportunity to discuss this subject with the Commission as soon as the board of governors has completed its analysis of floor trading, in the light of the studies by an outside consultant retained by the board and of other relevant information.

A second recommendation we view with concern involves off-board trading in listed securities (the so-called "third market") and dual trading of listed securities on the New York Stock Exchange and one or more regional exchanges. These practices have been accepted and encouraged both by the Special Study Group and by the Commission in its letters of transmitaal to Congress. Here again it is essential to recognize that diverting buy-and-sell orders from the primary market detracts from the liquidity of that market. We are particularly disturbed by the Commission's ready acceptance of the "third market" as a healthy influence.

No one questions that competition is an essential element of our free enterprise system. However, competition should be on an equal basis and competitors should be subject to similar restraints and controls. It is difficult to understand the logic that encourages a dilution of the primary market by the "third market" without subjecting the latter to the same regulatory conrols imposed on the former. Surely, the investor entering either market should be entitled to such safetguards as the public disclosure of price and volume information, the restrictions on short sales, the regulations governing dealers and traders in an exchange market, and the requirements that a fair and orderly market be maintained at all times.

The "third market" operates under the umbrella of the exchange's auction market, often gearing transactions to prices in our market. In times of crisis, however, over-the-counter dealers in listed securities are presently free to step away from the market or even use the exchange as a convenient dumping ground. And while there are many recommendations in the report which, if adopted, would affect the over-the-counter dealers in listed stocks, the overriding consideration—here as elsewhere—should be to maintain the highest possible degree of liquidity in the primary market. The continuing health and responsiveness of the primary market are by no means accidental or automatic. Its liquidity, its ability to provide tight markets in individual securities, to absorb or supply large blocks of stock, and to keep price changes within extremely narrow ranges, all depend upon the maximum accumulation—in the central marketplace—of orders from institutions and individuals alike. I believe it is abundantly clear that the problems which must be dealt with in this area are particularly complex. They involve not only degrees of regulation and responsibilities to the market, but rates of commission and dealer profits—among many other considerations.

The exchange welcomes the opportunity to study these problems internally and we look forward to discussing them in detail with the Commission and other interested parties in the months ahead.

A third general comment I would offer is that the Study Group's recommendations must be examined not only on an individual basis, but also as to their total impact on the entire securities industry. To put into effect and to enforce all of the recommendations would call for a significant expenditure of manpower and money. The industry's ability to bear such expense should by no means be taken for granted. It is true that in the specific years prior to 1962 covered by the report, the industry as a whole presented a reasonably healthy profit picture. A healthy industry is essential if the Nation's investors are to be served adequately and the Nation's industry is to obtain the capital necessary for expansion and modernization of its productive capacities.

It is also true that 1962 was not a very profitable year for the securities industry. The exchange, with the approval of the SEC, has developed an income and expense survey, which is designed to show the profitability of the commission business for our member firms from all sources—New York Exchange, American Exchange, regional exchanges, and agency transactions over the counter. The 1962 survey included 365 of our member firms, accounting for approximately 85 percent of all NYSE commission business during the year. The results indicate that in 1962 the average net profit of member organizations' commission business, after taxes, was four-tenths of 1 percent—with more than half of our member organizations showing losses. This, combined with a sharp decline in underwriting in 1962, presents a very unsatisfactory profit picture on which to superimpose the additional burdens that would result from indiscriminate adoption of the Study Group's recommendations.

I do not mean to suggest that action should not be taken promptly where its need has been clearly demonstrated. But I do mean that the efficient operation of an industry should not be stifled by restrictions designed to avoid or to eliminate an occasional situation. Neither governmental regulation nor self-regulation can hope to protect the imprudent investor against himself. I think it is extremely important that a point-by-point approach should not ignore the overall impact on the industry, and that any change should be based on clear evidence of its necessity. Each change must be both feasible and economically practical if, in the long run, the securities industry is to continue to serve the investing public.

CONCLUSION

In conclusion, I would like to return for a moment to the subject of self-regulation. The Special Study and the resulting legislative proposals reaffirm the wisdom of Congress in establishing industry self-regulation as a practical and effective method of providing investor protection. Nevertheless, a number of the Study Group recommendations call for Commission action in areas where the self-regulatory bodies themselves could act.

If self-regulation is to continue in the pattern established by Congress, then the basic responsibility of the self-regulatory bodies to adopt, revise, and enforce their own rules must be maintained.

We would like again to make the point that the exchange already has rules in many areas in which the Study Group recommends that the Commission adopt rules of its own. The Commission should act only when the self-regulators fail to make such changes, or when action is necessary in areas where the Commission has sole jurisdiction. The practical application of the concept of industry self-regulation with Government oversight requires the striking of a delicate balance in which Government should not become involved in the day-to-day self-regulatory operations. The proper role of Government is to determine the effectiveness of self-regulation by reviewing patterns and practices, leaving the daily regulatory job in the hands of the self-regulatory bodies. We believe that this was the relationship envisioned by Congress when passing the Securities Exchange Act, that the philosophy has been proved in practice over the years, and should be encouraged to continue its further development rather than to be curtailed.

We sincerely hope that, in accordance with this concept, implementation of any of the recommendations now under study will be sought where possible through the exchanges and the NASD.

In closing, I want to urge once again the passage of the proposed legislation before you.

EXHIBIT A.—S. 1642

STATEMENT OF G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE, BEFORE THE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING AND CURRENCY COMMITTEE, JUNE 21, 1963

My name is G. Keith Funston, I am president of the New York Stock Exchange and my home is in Greenwich, Conn. With me today are Edward C. Gray, executive vice president of the exchange, and Samuel L. Rosenberry, of Milbank, Tweed, Hadley & McCloy, counsel to the exchange.

I appreciate the privilege of apeparing before you to present the exchange's view on Senate bill 1642.

The bill before you would substantially reinforce two of the pricipal instruments of the Securities Exchange Act of 1934—disclosure and self-regulation. In addition, it would provide the SEC with new enforcement tools similar to those which the exchange, in the areas of our enforcement jurisdiction, has found to be essential.

ADEQUATE DISCLOSURE

The Federal Securities Acts presume that the public interest can best be served if adequate information is made available to investors—information on which they can base their own investment decisions in accordance with their own personal situation and objectives. While this has proved to be a very sound philosophy over the years, unfortunately it has not been applied universally. Companies which are listed on an exchange are required to furnish such information but those whose securities are not listed here have no such obligation. As the SEC Study Group found, a significant number of publicly held unlisted companies furnished no financial statements to their shareowners and many which did provide them had no certification by an independent accountant.

In the matter of proxy solicitation the shortcomings are equally serious. Twenty-nine percent of the industrial companies surveyed did not even solicit proxies. A sizable majority of the remainder failed to state the names of the nominees for election of directors and omitted to explain the effect on security holders of proposed mergers, consolidations, acquisitions, and similar matters. Based upon long experience in the area of its jurisdiction, the exchange does not believe that such lack of information should be permitted to continue with respect to publicly owned companies. This experience goes back to 1900. Since then the exchange has required listed companies to furnish prompt annual reports to stockholders and, since 1933, the financial statements in industrial companies' reports have had to be certified by independent public accountants. Beginning in 1955, companies applying for listing have agreed to solicit proxies for stockholders' meetings, a requirement extended to all listed companies in May 1959.

As regards publicly held banks, the exchange believes their shareowners should have much of the information which is presently made available to shareowners of listed companies. The exchange agrees that the administration of the act as it pertains to banks should rest in the hands of the Federal banking authorities. But it is absolutely essential that requirements affecting the banks should be the same whether the bank stocks are listed or unlisted.

Through the years the exchange has believed, and still maintains, that the investing public is entitled to adequate information concerning the affairs of publicly held corporations. Since 1941, it has advocated legislation to eliminate the illogical double standard under which the shareholders of unlisted companies do not receive the benefits of disclosure that listed companies are required to accord to their shareholders.

S. 1642 would extend to publicly held unlisted companies those provisions of the 1934 act relating to financial reporting, the solicitation of proxies and the disclosure by corporate insiders of their transactions in the equity securities of their companies. In the exchange's opinion, such a measure would go a long way toward the solution of the problem of inadequate disclosure.

GAPS IN SELF-REGULATION

A second basic principle of the 1934 act is that under Government oversight the securities industry should regulate and police itself to the maximum extent feasible. In general, the implementation of this philosophy has accomplished a great deal. While neither self-regulation, nor Government regulation, can

be expected to achieve perfection as long as human beings are involved, the approach has proved to be sound, However, there are several gaps in both segments of the present regulatory structure that need to be closed.

Persons lacking adequate training, experience, competence, or financial resources have on occasion been able to enter the securities business. Outside of the major exchanges, sufficient authority to set proper standards in these areas has been lacking. The result has been that in certain instances "boiler shop" operators and financially irresponsible people have been able to deal with the investing public.

The bill under consideration would empower the National Association of Securities Dealers to establish minimum capital requirements and appropriate standards with respect to training and experience and such other qualifications as it may find necessary or desirable. The bill would also require all broker-dealers to be registered with the SEC and be subject to the self-regulatory authority of an appropriate securities association. The exchange has long advocated such measures. In the area of its own jurisdiction it has seen how helpful the exercise of its self-regulatory authority can be to investors and indeed to the industry itself.

Since the earliest days, the exchange has passed on the character of those admitted to membership. From the turn of the century the program has included new partners in member organizations. In the early 1920's the screening was further extended to registered representatives, i.e., those employees of member firms who deal directly with the public. For more than 30 years we have required that registered representatives meet standards of experience. In 1936, the exchange instituted a requirement that these representatives demonstrate their knowledge of the securities business by passing an examination given by the exchange. At that time a minimum training period of 3 months was established; and in 1945, it was extended to 6 months. In the last 5 years the exchange has toughened its examinations, instituted special examinations for those charged with supervisory responsibilities and assisted member firms in strengthening their training programs.

Such procedures do not always succeed in screening out every "bad apple" or in assuring perfect performance, but the exchange is convinced that they have been of great benefit to the investing public.

The outstanding solvency record of its member firms can be largely attributed to exchange capital requirements. These have long provided that member organizations shall not permit their aggregate indebtedness to exceed a prescribed ratio to their liquid net capital. In addition, the exchange has a $50,000 minimum liquid capital requirement for firms carrying customer accounts and a $25,000 requirement for firms introducing customer accounts to another firm. These requirements and the exchange's mandatory fidelity bond coverage have been designed to maintain the financial integrity of our member firms for the protection of their public customers and others who do business with them.

The enactment of S. 1642 would benefit the investing public by enabling the NASD also to establish appropriate standards of competence and financial responsibility for those who deal with the public in the over-the-counter market.

SEC DISCIPLINARY CONTROLS

In enforcement of the securities laws the Securities and Exchange Commission has operated under a dual handicap, i.e., the lack of intermediate sanctions short of broker-dealer revocation and the inability to proceed directly against the individual violator except through action against his firm. Hence, the SEC has had to choose between permitting less serious violations to go unpunished or invoking overly harsh penalties that affect the innocent as well as the guilty.

Senate bill 1642 would permit the Commission to proceed directly against an individual who has violated the securities laws and to impose the intermediate sanctions of censure or suspension.

Over the years, the exchange has found these intermediate disciplinary measures to be effective in dealing with its member organizations, members, allied members and registered representatives who violate its rules. This approach permits, in addition to expulsion, the disciplining by censure or suspension of the people directly responsible for violations without putting an entire firm out of business. We support the proposal to add this flexibility to the Commission's disciplinary powers.

To sum up: S. 1642 would provide for closing major gaps in disclosure and self-regulation, and in the SEC's disciplinary authority—all of which should be beneficial to the economy and to the public.

The exchange urges that the bill be enacted.

EXHIBIT B

NEW YORK STOCK EXCHANGE,
New York, N.Y., October 18, 1963.

To: Members and allied members.
Subject: Stock exchange review of SEC Special Study.

For the past 6 months, the exchange has been engaged in a detailed examination of the several sections of the report of the Securities and Exchange Commission's Special Study of Securities Markets as they have become available. This letter is to bring you up to date on the progress we have made so far in that review.

It is, of course, no surprise to the members and allied members that the Special Study Group found no evidence of "fraudulent activity" involving this exchange. And while the report is critical of some specific details of exchange operations, in general it does not challenge in any basic respect the exchange's stewardship of the marketplace. Significant to the entire securities industry is the strong endorsement of self-regulation which appears conspicuously throughout the report.

A fresh perspective can often be obtained from a study made by people outside the exchange community. Guided by this realization the exchange has been carefully sifting the Special Study Group's recommendations as though they had been made by management consultants engaged by us. While we might disagree with the Special Study Group's identification of some questions as "problems"—and perhaps take issue with the emphasis or tone adopted toward others, and may wonder at some of the report's inconsistencies—nevertheless, it is important that each suggestion be examined fully and objectively in the light of what is best for investors and the Nation's economy. For the objective of the exchange is, and will always be, to provide the best marketplace possible for the investing public and the Nation's economy.

Most of the Special Study Group's 155 recommendations relating to the exchange community deal with questions or problems which have been identified and considered before, or which the exchange has been actively working on. Recommendations concerning floor trading, the specialist, and commission rates reflect areas of concern or debate which have been fully explored in the past. Problems of sales supervision and automation have received priority attention for several years. Energetic action in these areas predates the Special Study's interest by a considerable time.

As a result of the study the exchange assigned high priority to two problems. The Special Study recommended increased attention to member firms' presentation of their research activities, and the Commission asked the exchange to assume regulation of the odd lot differential. The broad supplements to the exchange rules governing member organizations' communications with the public, which were recently issued, include many of the Study Group's recommendations regarding statements about research. In September the Board agreed in principle to regulate the odd lot differential.

Most of the Study Group's recommendations regarding the exchange deal with the operation of the marketplace, a delicate mechanism serving the investment requirements of millions of individuals and institutions in this country and abroad. Our market is a working symbol of the free enterprise system, recognized and respected throughout the free world. But this symbol is also a very practical business entity, capable of dramatic reactions to injudicious tampering.

It is one thing from a theoretical viewpoint to recommend changes in the mechanism—and quite another matter to integrate such changes into day-to-day operations. Before theories can be activated, they must be thoroughly studied; their value to the public and their appropriateness within the overall economic picture must be assured. It is essential, for example, to maintain the market's liquidity and responsiveness to the national investment climate; and it is equally essential to avoid chipping away at the market's foundations by needlessly restricting the activities of any substantial group of buyers and sellers.

Thus, the exchange must not merely study the immediate and obvious implications of each specific SEC recommendation; we must also assess the broader and longer range impact which each may be expected to have on the overall operation of the marketplace.

The board of governors, of course, will determine exchange policies and positions, based on its consideration of staff findings, consultants' studies, the Study Group's report and the board members' own broad experience and knowledge of the securities business. To provide for orderly consideration of each recommendation by the board, a number of subjects have been assigned priorities, and special committees have been established to study the recommendations. A list of these special committees and the general area of their specific interests, with some examples of the recommendations, is attached. Copies of the several sections of the SEC Reported referred to are, or will soon be, available by writing the Superintendent of Documents, Government Printing Office, Washington, D.C.

The special committees are already at work. To assist them and the board, the exchange has engaged consultants to study three key areas covered by the report. An analysis of the cost of handling odd lot transactions will be conducted by Price Waterhouse & Co., the national accounting firm which devised the exchange's income and expense reports on member firms' commission business. Cresap, McCormick & Paget, an international management consultant firm, will obtain facts about floor trading. Joel Dean Associates—a firm of economic consultants headed by Prof. Joel Dean, of Columbia University—will examine present and possible future methods of measuring the effectiveness with which exchange specialists perform their function of endeavoring to maintain orderly markets.

The comments and opinions of the members and allied members will be most helpful and are solicited. They should be sent either direct to a member of the appropriate special committee or to the secretary of the exchange who will act as a clearing agent.

It is encouraging that SEC Chairman Cary has called for full discussion and study of all recommendations affecting the exchange. Several meetings have already been held and we are looking forward to future meetings in which governors and exchange community experts will participate. We are confident that all of these efforts offer the prospect of continuing progress toward a stronger marketplace, firmly based on the principle and practice of self-regulation and fully responsive to the needs of the investing public.

In addition to the special work involved in considering the SEC report, the regular work of the exchange obviously will go forward. As has been our practice in the past, we will continue to search out and adopt improvements in our methods, rules and regulations in all areas whether or not covered by study group recommendations.

G. KEITH FUNSTON.

SPECIAL COMMITTEES

I. Cost and Revenue
II. Floor Trading
III. Odd Lots
IV. Specialists
V. Steering

I. SPECIAL COMMITTEE ON COST AND REVENUE

Members

James F. Burns, Jr. (chairman)
Howard E. Buhse (vice chairman)

Harold L. Bache
Jacob Bleibtreu
Louis B. Froelich
Frank H. Hunter
Robert J. Lewis
Lloyd W. Mason
Walter Maynard
Chas. L. Morse, Jr.

1. Split of commissions for nonmember broker-dealers, chapter VI.I (2).
2. Service charges, chapter VI.I (4).
3. Procedure for varying the commission rate automatically when volume changes, chapter VI.I (6).
4. Increase of floor brokerage on discretionary orders, chapter VI.D (7).
5. Volume discount, chapter VI.I (3).
6. General study of both the rate structure and level of commission rates, chapter VI.I (5).

II. Special Committee on Floor Trading

Members

Walter N. Frank (chairman)

Andrew M. Baird	Gustave L. Levy [1]
James Campbell, Jr.	Joseph A. Meehan
Harold H. Cook	Harry C. Piper, Jr.
Richard M. Crooks	Albert Pratt

1. Abolition of floor trading, chapter VI.F (1).
2. Establishment of "auxiliary specialists," chapter VI.F (2).

III. Special Committee on Odd Lots

Members

D. Frederick Barton (chairman)

Harold H. Cook	Louis Meyer, Jr.
William J. Denman	C. Peabody Mohun
Benjamin Einhorn	Walter S. Robertson
Louis B. Froelich	Robert L. Stott
Stephen A. Koshland	

1. Cost study of odd lot business, chapter VI.E (2) (b).
2. Exchange regulating the odd lot differential, chapter VI.E (2) (a).
3. Exchange adopting rules with respect to handling of odd lot orders and odd lot dealers offsetting round-lot transactions, chapter VI.E (3).
4. Disclosure of odd lot differential in confirmations to customers, chapter VI.E (6) and VI.I (8)

IV. Special Committee on Specialists

Members

Henry M. Watts, Jr. (chairman)

John A. Coleman	John J. Phelan
Richard de La Chapelle	John J. Sullivan
Walter N. Frank	Milton R. Underwood
Robert J. Lewis	Alexander Yearley IV

1. Increase in specialists' capital requirements, Chapter VI.D (4)
2. Prohibit specialists introducing, carrying, or servicing public accounts, chapter VI.D (7) (f)
3. Prohbit specialists "stopping" stock against an executable order on the book, chapter VI.D (7) (c)
4. Prohibit specialists' long-term investment accounts and use of lifo basis, chapter VI.D (6)
5. Refine the obligations and responsibilities of specialists, chapter VI.D (2) and (3)
6. Abolition of specialists-corporate liaison program, chapter VI.D (special item)

V. Special Steering Committee

Members

Henry M. Watts, Jr. (chairman)
Walter N. Frank (vice chairman)

D. Frederick Barton	G. Keith Funston
Howard E. Buhse	Frank H. Hunter

1. Possible creation of associate memberships, chapter VI.I (2)
2. Extension of full or partial voting power to allied members, chapter XII.B (2)
3. Increased representation of public brokerage firms (nonspecialists) on the board of governors, advisory committee, nominating committee, and other governing bodies of the exchange, chapter XII.B (2) (b)
4. Limit the floor governors' ad hoc powers, chapter XII.B (3)

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[1] Also member of the Special Committee on Cost and Revenue.

5. Publicity by the exchange (with names) of censures (and fines) given by the board of governors or advisory committee, chapter XII.B(6)(b)
6. Examine relationship of exchange with the SEC and regional exchanges, chapter XII.J(1)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., October 16, 1963.

Mr. G. KEITH FUNSTON,
President, New York Stock Exchange.

DEAR MR. FUNSTON: As you know, the committee has before it H.R. 6789, which I introduced at the request of the Securities and Exchange Commission, and S. 1642, the companion bill, which has already passed the Senate, which embody legislative recommendations of the Commission growing out of the 2-year study it made pursuant to House Joint Resolution 438, 87th Congress, into the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations.

As of this date, we have not yet set a date at which we will have hearings upon this proposed legislation, but it is my intention to have hearings thereupon when the schedule of the committee's activities so permits. I am sure that you appreciate that inasmuch as the Commission's study was initiated and sponsored by this committee, the committee feels it incumbent upon it to consider this proposed legislation. At the time, the legislation is considered, however, it is the committee's intention to review the recommendations of the Commission as to legislation and as to what should be done under rulemaking powers, and also as to the Commission's special study findings on the adequacy of the rules of the exchanges and of the securities associations for the protection of investors.

In this connection I am sure that you already have given attention to the Commission's expressions and to the findings of the Commission's Study Group with respect to the adequacy of the various rules which you have enunciated as well as to some which might be deemed appropriate to be promulgated.

I am writing this letter to you accordingly in anticipation of the hearings which we shall have on the legislation and the study, and of your appearance before the committee at that time expressing your opinion thereupon so as to make sure that you develop in your appearance, if not before that time, your analysis of all of your rules and the comments of the Commission and of the Study Group on each of your rules as to the adequacy of each rule, for the protection of investors, and the suggestions of what additional rules should be considered by you.

Sincerely yours,

OREN HARRIS, *Chairman.*

NEW YORK STOCK EXCHANGE,
New York, November 15, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: We enclose 50 copies of our response to your letter of October 16, 1963, which asked for an analysis of the adequacy of all of the rules of the exchange and for an appraisal of the comments of the Study Group concerning the adequacy of those rules for the protection of investors. Exhibit A is an itemization of all of our rules not commented on by the Study Group or the Commission. Exhibit B is a list of all of the Study Group's recommendations affecting the New York Stock Exchange, and our staff comments on each of the recommendations.

The rules of the New York Stock Exchange are not static and over the years they have been continuously reviewed in order to meet changing needs and conditions in the marketplace. We believe the present rules of this exchange are adequate for the protection of investors. We would otherwise, of course, have moved to change or add to them. However, we are well aware that no set of rules is perfect. Evolutionary improvements are always possible and over the years we have been grateful for constructive suggestions as to how the exchange can better serve investors. It is in this light that the exchange is studying the recommendations made by the Study Group. I assure you that if

in the course of the exchange's analysis of the Study Group's report it appears that improvements in our rules are in order, they will be promptly considered and acted upon by our board of governors.

As I am sure you are aware, an in-depth analysis of the Study Group report is a tremendous task because of its bulk, the complexity of many of the matters discussed, and the relatively short period of time that has elapsed since all sections of the report have been generally available . Accordingly, it is impossible at this time to make definitive comments on many of the matters contained in the report that effect the New York Stock Exchange. Nor was it possible to present to our board of governors—with whom all final decisions rest—our comments which represent the view of the staff of the exchange based upon the analysis that it has been possible to make thus far.

In addition to the special work involved in considering the SEC report, the regular work of the exchange obviously is going forward. As has been our practice in the past, we will continue to search out and adopt improvements in our methods, rules, and regulations in all areas whether or not covered by Study Group recommendations.

Many of the recommendations could have a severe impact on the exchange market and, accordingly, our board of governors at its first policy meeting after the full report was available designated five special committees of the board to study the most important recommendations and those seeming to have the most immediacy. The five committees are: The steering committee, a committee on cost and revenues, a committee on floor trading, a committee on odd lots, and a committee on specialists. Exhibit B of the attached statement indicates those recommendations that have been assigned to a particular committee.

The board has already retained outside consultants to make studies in three extremely important areas: Price Waterhouse & Co. to do a cost study of the odd-lot business; Cresap, McCormick & Paget to make a study of floor trading; and Joel Dean Associates to study the methods for evaluating specialist's performance.

I want to reiterate several points made a month ago in an informational letter to our members and allied members. Most of the Study Group's recommendations regarding the exchange deal with the operation of the marketplace, a delicate mechanism serving the investment requirements of millions of individuals and institutions in this country and abroad. Our market is a working symbol of the free enterprise system, recognized and respected throughout the free world. But this symbol is also a very practical business entity, capable of dramatic reactions to injudicious tampering.

It is one thing from a theoretical viewpoint to recommend changes in the mechanism—and quite another matter to integrate such changes into day-to-day operations. Before theories can be activated, they must be thoroughly studied; their value to the public and their appropriateness within the overall economic picture must be assured. It is essential, for example, to maintain the market's liquidity and responsiveness to the national investment climate; and it is equally essential to avoid chipping away at the market's foundations by needlessly restricting the activities of any substantial group of buyers and sellers.

Thus, the exchange must not merely study the immediate and obvious implications of each specific Study Group recommendation; we must also assess the broader and longer-range impact which each may be expected to have on the overall operation of the marketplace.

It is encouraging that Chairman Cary has called for full discussion and study of all recommendations affecting the exchange. Several meetings have already been held and we are looking forward to future meetings in which governors and exchange community experts will participate. We are confident that all of these efforts offer the prospect of continuing progress toward a stronger marketplace, firmly based on the principle and practice of self-regulation and fully responsive to the needs of the investing public.

It is, of course, no surprise to the members and allied members that the Special Study Group found no evidence of "fraudulent activity" involving this exchange. And while the report is critical of some specific details of exchange operations, in general, it does not challenge in any basic respect the exchange's stewardship of the marketplace. Significant to the entire securities industry is the strong endorsement of self-regulation which appears conspicuously throughout the report.

In light of this endorsement, we hope that the self-regulatory bodies themselves will first be afforded full opportunity to make any changes that appear to be necessary in the public interest. We would like to point out that the exchange already has rules in many of the areas in which the Study Group recommends

that the Commission adopt rules of its own. The Commission should act only when the self-regulators fail to make such changes, or when action is necessary in areas where the Commission has sole jurisdiction. The practical application of the concept of industry self-regulation with Government oversight requires the striking of a delicate balance in which Government should not become involved in the day-to-day self-regulatory operations. The proper role of Government is to determine the effectiveness of self-regulation by reviewing patterns and practices, leaving the daily regulatory job in the hands of the self-regulatory bodies. We believe that this was the relationship envisioned by Congress when passing the Securities Exchange Act, that the philosophy has been proved in practice over the years, and should be encouraged to continue its further development rather than to be curtailed.

Sincerely yours,

G. KEITH FUNSTON.

EXHIBIT A

List of NYSE Constitution Articles and Rules, and Rules of the Stock Clearing Corp., Which Were Not Commented on in the "Report of Special Study of Security Markets"

NEW YORK STOCK EXCHANGE CONSTITUTION

Article I. Title, objects, definitions.
Article III. The board of governors.
Article IV. Chairman of the board of governors.
Article V. Vice chairman of the board of governors.
Article VI. President.
Article IX. Membership, allied membership, member firms, member corporations.
Article XI. Transfer of membership, termination of allied membership.
Article XII. Exchange contracts.
Article XIII. Insolvent members, suspension, reinstatement.
Article XVI. The gratuity fund.
Article XVII. The trustees of the gratuity fund.
Article XVIII. Emergency committee.
Article XX. Liability under previous constitution.

NEW YORK STOCK EXCHANGE RULES

Rule No.	*Topic heading*
1.	Effect of definitions.
2.	"Member," "Membership," "Member Organization," etc.
3.	"Security."
4.	"Stock."
5.	"Bond."
6.	"Floor."
7.	"Deliver exchange ticket."
8.	"Delivery."
9.	"Branch office manager."
10.	"Registered representative."
11.	"The exchange."
12.	"Business day."
13.	Disqualification of governors on listing of securities.
22.	Disqualification of governors because of personal interest.
23.	New York local time.
24.	Change in procedure to conform to changed hours of trading.
25.	Cost of production of records.
35.	Floor employees to be registered.
36.	Wire connections between exchange and members' offices.
37.	Visitors.
38.	Communications.
45.	Application of rules.
46.	Floor officials—appointment.
47.	Floor officials—unusual situations.
51.	Hours for business.
52.	Dealings on floor—hours.
53.	Dealings on floor—securities.
54.	Dealings on floor—persons.

56. Unit of trading—rights.
61. Recognized quotations.
62. Variations.
63. "When issued"—"When distributed."
64. 100-share-unit stocks.
65. Less than 100-share-unit stocks.
66. U.S. Government securities.
67. Convertible bonds.
68. Other bonds.
69. Disagreement, "fourth day" or "delayed delivery."
70. Below best bid—above best offer.
71. Precedence of highest bid and lowest offer.
72. Priority and precedence of bids and offers.
73. "Seller's option".
74. Publicity of bids and offers.
75. Disputes as to bids and offers.
76. "Crossing" orders.
77. Prohibited dealings and activities.
78. Sell and buy orders coupled at same price.
79. Bids and offers—binding.
80. Transmission of names of bidders, offerors, buyers or sellers.
85. Cabinet securities.
92. Limitations on members' trading because of customers' orders.
93. Trading for joint account.
94. Specialists' or odd-lot dealers' interest in joint accounts.
95. Discretionary transactions.
96. Limitation on members' trading because of options.
101. Registration of odd-lot dealers and brokers.
102. Options of odd-lot dealers.
103. Registration of specialists.
105. Specialists' interest in pools and options.
106. Taking book or order of another member.
117. Orders of members to be in writing.
118. Orders to be reduced on ex date.
119. Change in basis from "and interest" to "flat".
120. Discretion to employees, forbidden.
122. Orders with more than one broker.
131. Comparison—requirements for reporting trades and providing facilities.
132. Comparison—cleared transactions.
133. Comparison—noncleared transactions.
134. Differences and omissions—cleared transactions ("DK's").
135. Differences and omissions—noncleared transactions ("DK's").
136. Comparison—transactions excluded from a clearance.
137. Written contracts.
138. Give-ups.
139. Recording.
140. Members closing contracts—conditions.
142. Effect on contracts of errors in comparison, etc.
143. Stock clearing corporation orders.
151. Delivery day.
152. Failure to deliver.
153. Premiums and interest.
154. Renewal premium.
155. Renewal interest rate.
156. Premiums for one day only.
157. Premiums on basis of dollars.
158. Settlement of accrual premiums or interest.
159. Loans must be completed.
160. Notice for return.
161. Exchange employees not to participate.
165. Demands for marking to the market.
166. Demands for marking—procedure.
167. Deposits through clearing members only.
168. Failure to comply with demand.
175. Extension or postponement of contracts—power of board.
176. Delivery time.

177. Delivery time—"cash" contracts.
178. Contracts due on holidays or Saturdays.
179. "Seller's option".
180. Failure to deliver.
181. Delivery by certificate or transfer—personal liability.
182. Charges on transfer.
183. Payment on delivery.
184. Damages not to be deducted.
185. Denominations on delivery.
186. Coupon bonds.
187. Registered bonds.
188. "Small" bonds—"large" bonds.
189. Unit of delivery.
190. Deliveries of failures.
191. Foreign currency bonds.
192. "Part-paid" securities.
193. "Part-redeemed" bonds.
194. Stamp taxes.
195. Assignments.
196. Power of substitution.
197. Alterations or corrections.
198. Signatures.
199. Corporate assignments.
200. Assignments, by member organizations.
201. Assignments, by persons since deceased, trustees, guardians, etc.
202. Assignments, by insolvents.
203. Assignments, by dissolved member organizations.
204. Assignments, by continuing member organizations.
205. Assignments, change in member organization name.
206. Joint tenancy, special designation, etc., tenancy in common.
207. Two or more names.
208. Married women.
209. Signature guarantee.
210. Member signature is guarantee.
211. Out-of-town member executions.
212. Guarantee by insolvent.
213. Transfer books closed indefinitely.
214. Transferees in error.
215. Acknowledgments; affidavits.
216. Assignments of "rights."
217. Called stock or registered bonds.
218. Called coupon bonds.
219. Proper coupons, warrants.
220. Bonds registered as to principal or for voting purposes only.
221. Endorsed bonds.
222. Released endorsed bonds.
223. Mutilated bonds.
224. Mutilated coupons.
225. Delivery of equivalent securities.
235. Ex-dividend, Ex-rights.
236. Ex-warrants.
237. Buyer entitled to dividends, etc.
238. Charge for delivery of dividends or rights.
239. Claims for dividends, rights, etc.
240. Excess rights.
241. Interest, added to contract price.
242. Computation of elapsed days.
243. Interest computation, fractions.
244. Bonds, "and interest" dealings.
245. Income bonds.
246. Past due coupons.
247. Payment of interest or principal on bonds dealt "flat".
248. Registered bonds "and interest," due-bills for interest.
249. Registered bonds "flat," due-bills for interest.
250. Deliveries on or after interest dates.
251. Cash adjustment for coupons.

255. "Due-bill," "due-bill check" defined.
256. Forms of due-bills.
257. Deliveries after "ex" date.
258. Due bills, guaranty.
259. Due bills, redemption.
265. "Reclamation" defined.
266. Time for return.
267. Returns replaced immediately.
268. Within 10 days, currency, in market.
269. Endorsed bonds.
270. Exchangeable certificates.
271. Without limit, wrong security.
272. Lost or stolen, title questioned.
273. Partial call.
274. Married women.
275. Special cases.
281. Disagreement on contract.
282. Contracts of insolvents.
283. Members closing contracts—procedures.
285. Notice of intention to successive parties.
286. Closing portion of contract.
287. Liability of succeeding parties.
288. Notice of closing to succesive parties.
289. Must receive delivery.
290. Defaulting party may deliver after notice of intention to close.
291. Failure to fulfill closing contract.
292. Restrictions on members' participation in transaction to close defaulted contracts.
293. Closing contract in unlisted or suspended securities.
294. Default in loan of money.
299A. Civil defense alarm procedure.
299B. Federal agencies exempt from taxation.
301. Proposed transfer of membership.
302. Surplus of proceeds of membership transferred.
303. Limitation on access to floor.
311. Formation of or admission to member organizations.
312. Notice of changes within member organizations.
313. Submission of partnership articles—submission of corporate documents.
314. Fixed interest in business of partner.
315. Assignment, transfer, etc., of interest of partner or stock of stockholder.
316. Minimum of active partners in firms—use of a firm name.
317. Participant in one member organization.
318. Other connections of members and allied members.
320. Miscellaneous restrictions on corporate members.
321. Formation of corporate affiliates.
331. Disapproval of business connections.
332. Member acting as broker for controlled corporations.
333. Participation in commissions.
334. Joint offices.
335. Responsibility for controlled corporations.
341. Addresses of members.
343. Certificates of membership.
344. Control of offices.
346. Employees—fixed duties.
347(b). Controversies as to employment or termination of employment.
348. Registered representatives—limit of credit on own accounts.
349. Representatives of the press.
350. Compensation or gratuities to employees of nonmembers.
356. Discontinuance by exchange of any means of communication.
357. Retention of communications.
358. Wire costs for joint account arbitrage.
359. Communications with nonmembers.
365. Collecting commissions on "give-ups."
366. Transactions made outside of United States or Canada.
367. Deliveries on privileges.
368. Clearing charges.

369. Prohibited arrangements, etc.
370. Temporary absence from the floor.
371. Reverse operations.
372. "Bunched" orders.
373. Investment trust units.
374. Joint accounts with nonmembers.
375. Missing the market.
376. Payment of give-up commissions.
394. Off-floor transactions in listed stocks.
395. Off-floor transactions in listed rights.
396. Off-floor transactions in bonds.
401. Business conduct.
403. Bucketshops, etc.
404. Individual members not to carry accounts.
406. Designation of accounts.
407. Transactions—employees of exchange, member organizations, or certain nonmember organizations.
409. Statements to be sent to customers.
410. Records of orders.
411. Erroneous reports.
415. Accounts and securities.
416. Financial questionnaire.
417. Audit.
418. "Surprise" audit.
419. Financial statements to customers.
420. Reports of loans.
421(2). Periodic reports—on underwritings.
421(3). Periodic reports—collateral loans.
421(4). Periodic reports—customers' debit and credit balances.
422. Loans to and of governors, etc.
423. Participations in joint accounts.
424. Reports of options.
431. Margin requirements.
432. Daily record of required margin.
435(1). Excessive trading.
435(3). Successive transactions by members.
435(4). Manipulative operations.
435(5). Circulation of rumors.
435(7). Reopening a contract.
435(8). Loans for account of nonmembers.
436. Interest on credit balances.
437. International arbitrage.
438. Advertising in quotation sheets.
439. "Unit," "group," or "package" plans, participations.
440. Books and records.
465. Transmission of interim reports and other material.
499. Suspension from dealings or removal from list by action of the exchange.
500. Removal from the list upon request of the issuer.

STOCK CLEARING CORPORATION RULES

Rule No.[1]	*Topic heading*
1.	Definitions and descriptions.
2.	General provisions.
3.	Distributing department.
4.	Central receiving department.
5.	Clearance department.
6.	Central delivery department.
7.	Settlement department.
8.	Failure to deliver on security balance orders.
9.	Marking to the market.
10.	Federal and New York State transfer taxes.
11.	Special and special intermediate clearances.
12.	Settlement of commissions.
13.	Rights of the corporation in respect to securities and other property held.

[1] Rules of stock clearing corporation.

14. When the corporation declines to act for a clearing member other than in cases of insolvency.
15. Death, expulsion, or suspension (other than for insolvency) of individual clearing member or of sole exchange member of a clearing member firm or member corporation.
16. Insolvency of a clearing member.
17. Loss from insolvency of nonmember bank.
18. Suspension of rules.
19. Action by the corporation.
20. Charges for services rendered.
21. Fines.
22. Bills rendered.
23. Admission to premises of the corporation—powers of attorney, etc.
24. Forms.

EXHIBIT B

List of Recommendations by Chapter in the Report of Special Study of Security Markets. Also Included Are the NYSE Rules Related to the Recommendations and NYSE Staff Comments on Recommendations Where Applicable

CHAPTER I.—INTRODUCTION

A–B No recommendations. No NYSE comments.

CHAPTER II.—QUALIFICATIONS OF PERSONS IN THE SECURITIES INDUSTRY

A through E
No recommendations. No comments.

F

1–2–4–5
NYSE comment:
Compulsory membership in a self-regulatory organization for all broker-dealers, broadening of statutory disqualifications, and the unit approach for regulatory purposes are a part of the bill approved by the Senate and now before your committee, which the exchange has endorsed.

3
NYSE comment:
This recommendation requires further detailed study and discussion with the SEC.

6–7–8–10 (NYSE rule 345)
NYSE comment:
The exchange has required experience for registered representatives since 1930 and examinations since 1936. The exchange, in 1960, undertook extensive revision of its own examination program with the help of leading testing consultants. The NYSE provided a standard securities examination for the use of State securities commissioners in 1961. Coordination of the examination programs of the NYSE, NASD, and ASE became operational on July 1, 1963. Several States and the Midwest and Pacific Coast Exchanges are in the process of coordinating their examinations in the same system, administered in a nationwide network of testing centers under NASD direction. The exchange formalized its experience requirements for principals and branch managers in early 1962.

9 (NYSE rule 346)
NYSE comment:
The exchange for many years has required that all registered representatives should be full-time employees of member organizations.

11–12 (NYSE rule 325)
NYSE comment:
Exchange member organizations at present have an exemption from the SEC's capital rule inasmuch as the SEC deems this exchange's capital requirement (rule 325) to be more comprehensive than the SEC's.

The experience of the exchange over some 25 years, including times of stress, indicates that the NYSE's capital rule is adequate for the protection of investors. During that time there was only one insolvency, which would not have been prevented had the Study Group's recommendations been implemented before that time. In that 1960 case, the exchange offered, under certain conditions, to put up $690,000 to provide relief to

customers who had dealt in good faith and at arm's length with the firm. That insolvency was caused by the fraudulent acts of a general partner. The exchange then broadened its rules requiring that member corporations and members firms doing business with the public must have minimum fidelity bonds covering officers and employees, to require member firms also to have minimum fidelity bonds covering its general partners. The required minimum protection against possible loss due to fraud or dishonest acts by personnel was also raised, ranging from $100,000 for the smallest firms which do not carry customers' accounts, to $5 million for the largest firms carrying public accounts. In addition, the exchange itself took out excess fidelity bonds coverage totaling $10 million to come into play in the event a loss to an individual member organization exhausted its own fidelity bond coverage and all its other assets and those of its general partners.

Should the SEC revise it own capital rule along the lines of the above recommendations, this exchange strongly believes that its exemption from the SEC's capital rule should be continued.

CHAPTER III.—BROKER-DEALERS, INVESTMENT ADVISERS AND THEIR CUSTOMERS—ACTIVITIES AND RESPONSIBILITIES

A. Introduction

B. Selling practices

1 through 5

NYSE comment:

An intraindustry liaison group has met with the Commission and is giving prompt attention to these recommendations. It is not possible at this time to inform you of the exchange's ultimate position, pending further discussions between the liaison group and the SEC and consideration by the board of governors.

6 (NYSE rule 347)

NYSE comment:

Referred to steering committee to study and to report its findings to the full board of governors for its consideration.

7

NYSE comment: (See comment under recommendation II F(4).)

C. Research and investment advice

1 (NYSE rules 471–474A)

NYSE comment:

Under traditional standards of truthfulness the exchange has held member firms responsible for the accuracy of claims they make regarding their services and facilities. In addition, it has been contrary to our standards to make statements which are exaggerated. Regarding claims for research and portfolio analysis, the exchange has put specific standards into effect.

2

NYSE comment:

A number of these items have been covered by long-standing exchange standards or policies. For example, supporting information on recommendations had to be provided or offered; hedge clauses did not relieve a member organization from responsibility to exchange rules; investment literature had to be dated; predictions of future performance had to be labeled as opinion; claims of "inside" information by reason of a directorship and trading against recommendations would have been violations of our policies. Our standards and policies were supplemented by expanded or additional requirements in such areas as: substantiating recommendations; disclosure in connection with recommended securities; identification of sources of research; supplying bases of projections and predictions. The exchange would encourage use of 10K files if they were made readily accessible. The exchange believes that its present standards as expressed in 2474A are adequate and practical in the area of this recommendation.

3 (NYSE rule 472)

NYSE comment:

Since 1956 when the exchange pioneered market letter review, the exchange has consistently expanded and strengthened its program. At that time a sampling of each firm's production was checked about once every 3 years. In 1959, review was stepped up to once every 2 years. By late

1962, the rate of review was increased to at least once every 6 months. Early this year a separate unit was established in the advertising department to handle review activities exclusively, with an authorized staff expansion of five persons.

In January 1963 educational conferences on the review operation and standards were started. Circulars explaining exchange standards have been distributed to firms. Checks are made on firms' positions and disclosure of intentions, market making activities and special relationships in recommended stocks. A new program started early this year evaluates the ability of a firm to live up to claims of research facilities, services, and capabilities made in advertising and promotional material. To further strengthen the review program, the board of governors adopted new standards in September.

4

NYSE comment: (See comment under recommendation III B(1) through (5).)

D. Protection of customers' funds and securities

1–4 (NYSE rule 325)

NYSE comment: (See comment under recommendation II F(11).)

2–3–5

NYSE comment:

See comment under recommendation III B(6)—Exchange rules already require for member firms the practices under recommendations 2 and 3.

E. Delivery of securities

1 (Clearing corporation rule 9)

NYSE comment: (See comment under recommendation III B(6).)

2 (NYSE rule 284)

NYSE comment: (See comment under recommendation VI E(4).)

3

Not applicable to the exchange.

4

NYSE comment:

The exchange not only agrees with this recommendation but points to the initiative of the clearing corporation in seeking improved methods for serving its clearing members which have benefited by the adoption of a number of improvements during the past several years. At present, two important projects in progress are (1) test of a compared clearance and (2) a central handling of securities method.

The exchange welcomes and encourages steps designed to increase member organization efficiency and reduce costs. The exchange approved the first joint bookkeeping operation for member firms in 1951. In October of 1960 the exchange published a report describing the four joint bookkeeping operations in Los Angeles, New York City, San Francisco, and Pittsburgh. This was followed by a large conference on the same subject open to all member firms, and printing of the "proceedings" in a second publication. In September 1963, the exchange approved of member organizations establishing affiliated corporations to offer bookkeeping services to other securities firms.

F. The broker-dealer as corporate director

1

NYSE comment:

Over the years, the exchange has been a leader in defining ethical conduct in conflict of interest areas and has publicized its views in a number of circulars and educational publications.

CHAPTER IV.—PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC

A. Introduction

B. New issues

1 through 7

Not applicable to the exchange.

8

NYSE comment:

The clarification suggested would be extremely helpful to the entire securities industry.

C. Unregistered distributions
1 (NYSE rules 391–3)
NYSE comment:
This is a question of broad importance beyond the exchange market. Consequently, it merits careful study before any change.
D. The intrastate exemption
Not applicable to the exchange.
E. Real estate securities
Not applicable to the exchange.
F. Integration with previous filings
1–3
NYSE comment:
These recommendations require further study.
2
NYSE comment:
The exchange would be pleased to study any suggested revisions of SEC forms the Commission may propose in this area.

CHAPTER V.—TRADING MARKETS—INTRODUCTION

A–B–C No recommendations. No NYSE comments.

CHAPTER VI.—EXCHANGE MARKETS

A through C
No recommendations. No comments.
D. Specialists (NYSE rules 91, 104, 107, 108, 109, 110, 115, 116, 121, 123, 125)
1 through 11(c)
NYSE comment:
Referred to special committee on specialists to study each of the recommendations in this area and to report its findings and recommendations to the full board of governors for its consideration.
With respect to specialists' capital requirements, the exchange has had minimum requirements since 1939. Since that time, and particularly in the last 10–12 years, the exchange in its surveillance of the dealings by specialists has placed more emphasis upon his proper functioning in endeavoring to maintain fair and orderly markets than upon the amount of his available capital. As a result specialists have had to obtain the capital necessary to meet their dealer responsibilities. While the exchange may be favorably inclined to increase the specialists' minimum capital requirements along the lines recommended by the study group, it might be pointed out that the group, while recommending such increase, also recommended the elimination of a number of effective means available to specialists for augmenting their capital.
For 7(b), also see comment under recommendation VI.I (1) through (6).
E. Odd lot dealers (NYSE rule 55)
1–2–3
NYSE comment:
Referred to special committee on odd lots. The board of governors has agreed in principle that the exchange regulate the odd-lot differential, the manner or method to be determined after completion of a cost study. The board of governors also agreed, in principle, that the exchange should prescribe rules or policies governing the handling of odd-lot transactions and offsetting round-lot transactions, and should devise an appropriate surveillance system. (The manner of executing odd lot orders has been widely publicized through booklets distributed by the two large odd-lot dealer firms.) The exchange has retained Price Waterhouse & Co. (who devised the exchange income and expense study of the commission business) to understake a cost study of the odd-lot business.
There are no rules of the exchange relating to automation and none were suggested. While improvements in operating procedures and mechanics are continuously being sought, the exchange regards present procedures in these areas adequate for the protection of investors.
The report acknowledges that "technological innovations have been utilized increasingly in the exchange markets," and cites the "important automated techniques" introduced by the NYSE clearing corporation. Additional programs in the automation area presently underway include not

only installation of a new, higher speed ticker by the fall of next year but the complete automation of our ticker and quotation bid-ask operations in 1965.

These plans do not include automation of the odd-lot operation nor are we in a position at this time to determine the feasibility of automating that operation. They do include provision for members obtaining last sale service through the exchange's quotation bureau and, although policy questions involved have not yet been submitted to our board of governors, we contemplate that the odd-lot firms would withdraw as far as practicable their present last sale service at that time.

The exchange has a tremendous interest in any change that will improve the quality of its service to the public. We have been constantly seeking improvements in the efficiency of the exchange operation. Possible changes in our procedures are, of course, of particular concern to us in connection with our new building plans. In this connection, we are at the present time studying the possibility of utilizing electronic switching equipment for the transmission of odd-lot orders and, possibly, of orders directed to specialists on the floor.

Our studies in this regard have led to discussions during the past year with the two principal odd-lot dealer firms as to possible use by them of computers to assist in the handling and execution of odd-lot orders. Present thinking of the odd-lot firms is that any change as fundamental as that involved, affecting as it would not only the operations of the odd-lot firms but of all of the member organizations originating such orders, if found feasible could only be accomplished as a practical matter on some step-by-step basis.

The old-lot firms are therefore proposing that studies in this area be concentrated in the immediate future in the development of a system for the handling of market orders in odd lots through a computerized operation, looking toward a possible experiment or test which could be used as the basis of further planning and implementation.

All of the study group's recommendations in the automation area will require further studies not only from the viewpoint of technical feasibility but from the viewpoint of the economics and operating problems involved, before management decisions in this area can be made.

F. Floor traders (NYSE rules 108, 109, 110)

1–2

NYSE comment:

Referred to special committee on floor trading. The exchange feels strongly that the auction market needs the liquidity and price continuity contributed by all segments participating in the market, including floor trading.

A special committee on floor trading has been established to study these recommendations and to report its conclusions to the board of governors for its consideration. To assist them and the board, the exchange has engaged Cresap, McCormick & Paget, an international management consultant firm, to obtain facts about floor trading.

Chairman Cary of the Securities and Exchange Commission indicated in his letter to the Congress, dated about July 19, 1963, that the exchange would be given an opportunity to demonstrate that the continuance of floor trading "would be consistent with the public interest." The exchange has asked for the opportunity to appear before the Commission after the board of governors has considered the report of the special committee on floor trading.

3

Not applicable to NYSE.

G. *Members off-floor trading*

1

NYSE comment:

Requires further study.

H. Short selling (NYSE rule 123)

1–2–3

NYSE comment:

Requires further discussion and study.

I. Commission rates (NYSE rules 377, 378, 379, 380, 381, and article XV of the exchange constitution)

1–2–3–4–5–6

NYSE comment:

Referred to special committee on member firm costs and revenues. It is not possible at this time to inform you of the exchange's ultimate position, pending completion of studies underway, discussion with the SEC and consideration by the board of governors.

Some of the recommendations call for reductions in commissions paid by nonmember broker-dealers and volume discounts. A major problem in the consideration of feasibility of these recommendations is the fact that our latest security commission income and expense survey for the calendar year 1962 shows that the aggregate net profit from the security commission business for 346 member organizations (after applying estimated Federal income taxes on a corporate basis) was four-tenths of 1 percent—an extremely low net profit. For 1961, the aggregate net profit was 5.8 percent (after such taxes) for 150 organizations. Of the 346 member organizations, 193 firms, over 56 percent, operated at a loss in their security commission business as compared to 1961, when only 24 firms, or 16 percent, of the 150 firms incurred losses.

In considering the above results, one should bear in mind that the reported exchange volume for the year 1961 was the second highest in history. The 1962 volume was the third highest. The NYSE commission business generated by the 346 firms in 1962 represented in excess of 85 percent of all NYSE commission income and over 90 percent of the NYSE commission business of firms doing business with the public.

That part of recommendation 6 covering mandatory reports has been referred to the steering committee. (See comment under recommendation III B6.) The exchange will continue as it has in the past to encourage member firms to supply income and expense information. The exchange initiated these studies in 1952, when 40 firms voluntarily submitted information, about a tenth of the possible total. In 1962, seven out of every eight firms carrying customers accounts with the public participated, even though the report forms had increased greatly in detail and difficulty, and in the burden and cost of preparation. The revised report form was designed by Price Waterhouse & Co., after 2 years of effort on a cost study, based on a more refined cost accounting approach than had been used in the past.

7 (NYSE rule 26)

NYSE comment: (See comment under recommendation III. B 6.)

8

NYSE comment: (See comment under recommendation VI. E 1–3.)

J. Automation—its needs and possibilities

1–2–3

NYSE comment: (See comment under recommendation VI. E 4.)

Chapter VII.—Over-the-Counter Markets

A through E. No recommendations. No NYSE comments.

F. Summary, conclusions, and recommendations

NYSE comment:

Although the recommendations are in an area which is not an NYSE primary responsibility, their implementation may be of indirect interest to or have an effect upon this exchange. They, therefore, require further study and discussion with the other agencies concerned.

Chapter VIII.—Trading Markets—Interrelationships

A. Introduction

No recommendation. No NYSE comment.

B. The basic allocation between exchanges and the over-the-counter (as primary markets).

1.

NYSE comment:

While the appropriateness of a security's listing on the exchange cannot be measured mathematically, several qualitative standards and criteria have been devised in order to keep interested parties better informed of the eligibility of a company's common stock for original and continued

listing on the exchange. These have been periodically revised and amplified in the light of general economic conditions and to reflect the added experience of the exchange with the problems inherent in endeavors to maintain fair and orderly securities markets. In recent years increases in listing standards were made in 1944, 1947, 1950, 1958, and 1961 and in delisting criteria in 1958 and 1961.

As outlined in the report of Special Study of Securities Markets, proposed legislation would eventually add 6,910 issuers to those reporting under the 1934 act.

A review of NYSE prospect list indicates 163 companies excluding banks and insurance companies which appear to meet NYSE standards. NYSE studies indicate 82 banks and insurance companies in this category, making a total of 245 altogether that appear to be eligible under present listing standards.

The New York Stock Exchange will in the future continue to review its original listing standards and delisting criteria.

2.

NYSE comment: (See comment under recommendation VI.E(1)(2)(3)).

3.

Not applicable to NYSE.

C. Institutional participation and block transactions

1–2.

NYSE comment:

Referred to Special Steering Committee to study each of the recommendations in this area and to report its findings and recommendations to the full Board of Governors for its considerations.

3.

NYSE comment: (See comment under recommendation VI.I (1 through 5)).

D. Over-the-counter market in exchange-listed securities

1.

NYSE comment: (See G. K. Funston's statement).

2–3–4–5–6.

NYSE comment: (See comment under recommendation VII).

E. Allocation among exchanges—the regional exchanges as primary and secondary markets

1.

NYSE comment :(See comment under recommendation VIII.D(1)).

2.

NYSE comment: (See comment under recommendation VI.I(1 through 5)).

3.

NYSE comment: (See comment under recommendation VIII.C(1)(2)).

4.

NYSE comment:

The exchange has endorsed SEC legislative proposals in this area. (See comment under recommendation VIII.B(1).)

5.

NYSE comment: (See comment under recommendation VIII.C(1)(2)).

F. General considerations

1–2–3.

NYSE comment: (See comment under recommendation VIII.C(1)(2)).

Chapter IX.—Obligations of Issuers of Publicly Held Securities

A. Introduction

No recommendation. No NYSE comment.

B. Protection for investors in listed and unlisted securities

1–2–3–4–5–6.

NYSE comment:

The exchange has endorsed the SEC proposals in this area.

7. (a)

NYSE comment:

The exchange generally agrees that financial statements in reports to stockholders should be on substantially the same basis as the SEC reports but feels that the flow of information in form readily understood by stockholders and investors should not be impeded.

(b)

NYSE comment:

The exchange has endorsed the SEC legislative proposals.

(c)

NYSE comment:

The SEC did not include this area in its legislative proposals.

8. NYSE comment: (See comment under recommendation III.B(1 through 5)).

C. Corporate publicity and public relations

1.

NYSE comment:

NYSE has been a leader of high standards for dissemination of corporate information. The special study commented favorably on the exchange prompt disclosure policy and its implementation.

2.

NYSE comment:

Possible benefits from this type of legislation must be weighed against the effect it may have in impeding present flow of valuable and timely information to present investors and potential investors.

3.

NYSE comment:

For new issue stock, stockholder approval would generally be required under exchange policy unless the amounts involved are de minimus. The other disclosure recommendations are being studied.

Chapter X.—Security Credit

A through C.

No recommendations. No comments.

D.

1–2–3–4–5.

NYSE comment:

Chairman Cary pointed out that these recommendations relate to matters within the province of the Federal Reserve Board and stated to your committee that while the Commission will not initiate any action, it will work closely with the Federal Reserve to resolve the problems.

The exchange has supported the principles embodied in recommendations 2, 3, and 5, at various times in the past—for example in connection with the 1958 Fulbright bill, not enacted.

The proposed initial margin requirements on nonpurpose loans and additional requirements for loans on convertible bonds, however, should not be acted upon without more thorough study of possible effects.

Chapter XI.—Open-End Investment Companies (Mutual Funds)

A. No recommendations. No NYSE comments.

B. Not applicable.

C. Reciprocal business. The problems of allocating mutual fund portfolio brokerage.

1. NYSE comment: (See comment under recommendation VI.I (1–5)).

2–3. Not applicable.

D. Not applicable.

Chapter XII.—The Regulatory Pattern

A. Introduction:

No recommendation. No NYSE comment.

B. The NYSE as a self-regulatory institution (rule 345).

1. No recommendation; no NYSE comment.

2–3.

NYSE comment:

Referred to the special steering committee to study each of the recommendations in this area and to report its findings and recommendations to the full board of governors for its considerations.

4.

NYSE comment: (See comment under recommendation VI.E(4)).

5

NYSE comment:

There is no exchange rule governing public complaints, this recommendation dealing instead with administrative procedures of the exchange.

The exchange's complaint handling procedure for many years has had three parts: (1) an initial inquiry concerning basic facts, with a report to the customer which very frequently revolves the complaint, (2) reference of complainant to arbitration or litigation for adjudication of claims where the initial inquiry shows an irreconcilable dispute, and (3) consideration of possible conduct aspects of the complaint.

It would not appear appropriate for the exchange to follow a practice of giving customers legal advice on the merits of their claims. The exchange does not adjudicate customers' claims for damages. However, the exchange has provided arbitration facilities for the resolution of such controversies. Where the conduct aspect of a complaint is not clear, the exchange also frequently holds conduct consideration in abeyance during the process of arbitration or litigation which may develop additional evidence of misconduct.

The volume of complaints submitted to the exchange approximately doubled in 1961–62. As a result, the exchange took action to increase its capacity for handling complaints by establishing a separate division of inquiries and complaints and increasing personnel assigned to this work. It is believed that the strengthening of the administrative staff devoted to complaint handling permits sufficient investigation of complaints to bring to light any possible underlying conduct violation.

6.

NYSE comment:

(See comment under recommendation XII.B(2)(3).

7.

NYSE comment:

The exchange believes that public relations and advertising activities which emphasize the quality of the exchange's market and members are not inconsistent with the exchange's self-regulatory functions.

Pointing up demonstrated merits and standards of the community contributes to the effectiveness of self-regulation while adding to public understanding. It is precisely when the public is unaware of the standards and ethics of the community that they are most likely to accept less than the best from the community. Moreover, public reiteration of high standards acts as a strong incentive to the exchange community to adhere to them.

C. The American Stock Exchange as a self-regulatory institution.

Not applicable.

D. The Midwest Stock Exchange as a self-regulatory institution.

Not applicable.

E. The Pacific Coast Stock Exchange as a self-regulatory institution.

Not applicable.

F. The other exchanges as self-regulatory institutions.

Not applicable.

G. The NASD as a self-regulatory institution.

Not applicable.

H. Certain quasi-self-regulatory organizations.

Not applicable.

I. Self-regulation and the Commission (rule 26).

1–2–3

NYSE comment: requires further discussion and study.

4.

NYSE comment:

(See comment under recommendation VI.I(1–7)).

5.

NYSE comment:

Disciplinary procedures in which registered and nonregistered employees of member organizations are involved have been conformed in substance to those applicable to proceedings in which members and allied members are involved. In addition, such employees have been

given the right to appeal staff disciplinary action to the board of governors of the exchange.

Since September 1961, the exchange has not passed on nonmember applications for private wire connections or ticker service.

In view of its present procedures, the exchange does not believe that SEC review of its disciplinary actions is either necessary or desirable.

6–7.

No recommendations; no NYSE comments.

J. The total regulatory burden—The need for increased coordination—The tole of the States.

1. NYSE comment: (See comment under recommendation XII.B(2)(3)).

CHAPTER XIII.—THE MARKET BREAK OF MAY 1962

A through D

No recommendations. No comment.

E

NYSE comment:

Referred to Special Committee on Specialists to study and to report its findings to the full Board of Governors for its consideration.

Mr. STAGGERS. I am informed that you just returned from a 2-week trip to Russia.

Mr. FUNSTON. Yes, sir.

Mr. STAGGERS. We welcome you back and are glad that you got out. Apparently they only detain professors and not ex-college presidents.

Mr. FUNSTON. We didn't know that he was locked up while we were there or we would have had much more disquiet, I believe.

Mr. STAGGERS. I am glad you are back. I want to thank you for appearing. I don't know how much time we will have, but I will commence the questioning with our chairman, Mr. Harris. We will not have too much time tonight, however.

Mr. HARRIS. I will yield at this time, Mr. Chairman.

Mr. STAGGERS. Mr. Glenn.

Mr. GLENN. I take it you approve of the legislation we are considering. Your comments are almost exclusively directed to the rulemaking portion of the study which was made and as being applied by the Commission or to be applied by the Commission.

Mr. FUNSTON. Yes. We favor the legislation. I made those additional comments because in the letter from Chairman Harris I thought that some general comments about the study were asked for.

Mr. GLENN. Of course, you don't presume that we will do anything about the rulemaking end of it, do you?

Mr. FUNSTON. No, sir.

Mr. GLENN. Thank you very much. That is all.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. If I remember rightly, Mr. Funston, you weren't very enthusiastic about this study at the time it was suggested to the Congress 2 years ago.

Mr. FUNSTON. Well, when I was made clear of the scope of it, that it was going to be carried on by the SEC, and that they were going to get an additional sizable appropriation so that it could be carried on in addition to the other matters that we had before them, without those getting bogged down and delayed, I favored the study.

Mr. KEITH. During the course of the committee's consideration of this problem, we called on you at the stock exchange, observed its operation, and had some discussions in your office. One of the subjects which you and I discussed was the problem of obtaining good

personnel to be the officers of the exchange, and also, of course, members of the exchange.

At that time, I had just read in Time Magazine, I believe, that the President of the United States had directed the Income Tax Division to review the income tax returns of those persons he was considering appointing to high office, to make certain that these men had not been guilty of conduct that might indicate that they were not qualified for the offices to which he was appointing them.

I suggested that you might have auditors adopt a similar practice with officers of the exchange. Do you recall that?

Mr. FUNSTON. Yes, I remember particularly discussing that with you with respect to future members of the board of governors and officers of the exchange. Yes, sir.

Mr. KEITH. I think we discussed it with reference to the board of governors because of the *Bidwell* case which was then pending.

Mr. FUNSTON. Yes, sir; that is correct. And we followed that suggestion. That is being very closely checked on now and has been since we had our discussion.

Mr. KEITH. I am glad you adopted that procedure.

In that connection, I am reminded that when the *Bidwell* case was finally resolved, it was revealed that these expenses under question by the Bureau of Internal Revenue dealt with the payment of gratuities to employees of member firms. Was any action taken to prohibit the continuation of this kind of practice?

Mr. FUNSTON. Yes. What happened in that case was, as soon as the court records were available, we got hold of that and Mr. Bidwell was interrogated in depth and so were many other people. It was found that on a number of the gratuities that he gave he had not followed the established procedure and asked and obtained the advance approval of the employers of the persons to whom the gratuities were given, and the exchange. So he was censured very severely.

We had at the time a very broad, blanket rule which was written very broadly because we wanted to make sure it was broad enough to catch most any kind of a malefactor. The rule was so broad that it was very hard for anyone to live up to it completely. The board was convinced that his violations were not willful, that where he did not seek approval, had he sought it the board would have granted approval, or the exchange would have, and since then we have changed the rule to make it a much more workable one and one which can be much more readily enforced.

Mr. KEITH. The implication of the news story that I read was, to the best of my recollection, that these gratuities might have been given for the purpose of obtaining information as to what action a member firm might be going to take which could be reflected in the price of a stock on the exchange.

Mr. FUNSTON. Mr. Keith, that was not my impression of it. My impression was that the thing that we were looking for, of course, was to make sure that there was no rebate of commission or buying of business or special services involved. After studying it very carefully, the board concluded that that was not the case.

Mr. KEITH. The amount of money involved, if I recall correctly, was in the vicinity of $20,000.

Mr. FUNSTON. There were so many figures that were given in court and outside that I am not exactly sure what the figure is you have in mind. My impression was that over a period of several years, it amounted to about $30,000, but I would have to refresh my memory on that. That was over a period of years, several years.

Mr. KEITH. My purpose in bringing this up is to make the record clear that these gratuities were in no way to compensate for insider information.

Mr. FUNSTON. They were not, sir; no, sir.

Mr. KEITH. The purpose really was generosity on the part of Mr. Bidwell to his close associates.

Mr. FUNSTON. The people involved were mainly those on the floor of the exchange who help him out during the year, whom he works with, and so on. There was no inside information being bought at all.

Mr. KEITH. It is inconceivable to me, coming from New England, for someone to give gratuities in that amount.

Mr. FUNSTON. He does a very big business, sir. He really does a tremendous business. It is a small percentage of his total money, his total gross income.

Mr. KEITH. The NASD is the voluntary regulatory body for broker-dealers in the over-the-counter market. When there is a disciplinary action taken by that organization, the individual who is so affected has an appeal to the SEC and to the courts, is that correct?

Mr. FUNSTON. Yes.

Mr. KEITH. This isn't true with people who are the object of your disciplinary action?

Mr. FUNSTON. No, they do not, under the statute. Of course, any thoughts that the SEC would have on an individual action we would discuss with them very freely and welcome their views. The type of control that the SEC has over us in this area is that should we be handling disciplinary actions in a way that they did not think was appropriate, they could direct us to write a rule to make this be handled in accordance with the way that they thought they ought to be handled, and then if we didn't adopt the rule, then they could call a public hearing and at the end, 30 days after the public hearing, could direct us to write the rule.

It is a more indirect way to review our disciplinary actions than is provided for in the NASD.

Mr. KEITH. You attempted to discipline a firm, I believe, in Texas, which had not complied with your regulations with reference to equipment. I believe it involved the removal of some of your equipment from their office. The Supreme Court concluded that you were in error in this respect, did it not?

Mr. FUNSTON. That is right.

Mr. KEITH. Has this had an adverse effect on your attempt to discipline your membership?

Mr. FUNSTON. It has not had an adverse effect on disciplining our membership. It has caused us, however, to stop policing the tickers and the direct wires that go from our members to nonmembers. A nonmember was involved here. Many years ago, when we were trying to do everything that we could to do away with the bucket shops in the areas outside the exchange's jurisdiction, we made it a requirement that no person could have a ticker or direct wire with a member unless they were approved by the exchange after an investigation.

Because so few people were not approved, we adopted the policy of giving approvals to nonmembers, pending investigation, subject to a written agreement on the part of that person that should anything illegal be found, that they would agree to discontinuing the ticker. We did that for many years, sort of pro bono publico, thinking that was part of our responsibility.

We got challenged in this. The Supreme Court reversed the circuit court and said we had no right to do this and in so doing made ourselves subject to the antitrust laws. So we have withdrawn from this area, and any person who wants a wire can have it.

This decision, of course, was a very far-reaching one. We have studied all the rules of the exchange to make sure that insofar as we can anticipate, we conform to the principles that were laid down by this decision. The decision went against us mainly because we did not give what they called "due process." We have made every effort since, in our relationships to our approval of registered representatives, and all members of the exchange community, to follow due process.

It has slowed up our operations very much, I might add, and has caused us to put on a number of added people, and so on, but we believe that we are getting a reasonable protection by following procedures similar to those we use with our own members.

Mr. KEITH. Do you feel that there is any need for legislation in this regard?

Mr. FUNSTON. No, sir.

Mr. KEITH. On a new subject, it is our understanding that there has been some change in the requirements or standards for education and for licensing of members of the exchange, or I should say of dealers who are not members of the exchange.

Mr. FUNSTON. There hasn't been anything particularly new in that as far as we are concerned. Over the years, of course, every person who comes in as a member or allied member has to be individually approved by the board of governors, based on his character, financial capacity, and experience, and all registered representatives, that is, the salesmen, have to be approved by the exchange. Most of these people are investigated by a private investigation source.

What we did back about 4 years ago, progressively as you go along, is that you continually raise the standards in this regard. I think it was in 1960 we put in much tighter examinations to measure training, and as we go along we improve. We are just putting in a new examination now for branch managers.

I don't know what you mean, Mr. Keith, but if you would be more specific, I will try to be responsive.

Mr. KEITH. It has been suggested that the NASD might require financial responsibility, with a larger minimum capital requirement, than perhaps many small dealers could raise. For example, up to $25,000 for a broker-dealer office in the way of capital requirements, and perhaps a college degree in order to qualify as a salesman.

Mr. FUNSTON. Of course, with respect to the capital requirements of broker-dealers, I am all for that. I think that is a very healthy thing. We have had such capital requirements for our members for many, many years. The minimum capital now for anyone carrying public accounts is $50,000. I am not sure exactly what figure the NASD would have in mind. I had not heard that $25,000 was what they had in mind. The figure that sticks in my mind is $5,000.

Mr. KEITH. In the District of Columbia, I believe they suggested $25,000 at one time.

Mr. FUNSTON. I think that is probably just off the cuff, but I think that would be high, although I am not an expert in this. New York State has put in a new requirement this year of $5,000. I think something of that magnitude might be very desirable. I would submit that if someone didn't have that much capital, he probably shouldn't be in the business of advising other people on how to build capital.

Mr. KEITH. What proposals do you have in mind when you refer to a number of recommendations by the Special Study calling for SEC action, and which you feel could be handled under the self-regulatory procedures?

Mr. FUNSTON. Well, some that affect us are capital requirement rules, giving the SEC power to require segregation of excess margin and fully paid securities, giving the SEC rulemaking power to restrict pledging of customer securities to a reasonable relationship to debit, requiring the same financial reports and published statements as in forms filed with the SEC, passing rules requiring broker-dealers to transmit proxy material, the SEC to pass on the Saperstein policy in rule form, and rule 11(b), to affirmatively require specialists to deal. These are the particular ones I had in mind.

Mr. KEITH. Thank you.

Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Harris?

Mr. HARRIS. I want to express my thanks to Mr. Funston for his testimony today and presentation to the committee, and for his cooperation in complying with the request which we made of him by letter of October 16, which is referred to, in which he gave the committee the benefit of the information from his organization, articles and rules, and so forth, as set out, and in which he enumerates the rules—a good many of them, around 500 or a little less—and then the comments on some of them as have been set out in the document presented.

I could take the time, Mr. Chairman, to ask a good many questions along the line I asked the Commission, but I don't think we have the time to do it. I would like to ask Mr. Funston if he is familiar with the objections of the insurance people, the State insurance commissions, and so forth, to certain provisions of this proposal.

Mr. FUNSTON. I am generally familiar with it, sir, and I heard your questioning of Mr. Cary, so I think I have a pretty good idea of what they are; yes, sir.

Mr. HARRIS. Do you have enough information on it to know whether or not their fears are justified?

Mr. FUNSTON. I used to be a director of two stock insurance companies, and I am a director now of a mutual, a big mutual company. It doesn't seem to me that the request or that the requirement would be any undue burden at all on the insurance companies; I think, as a matter of fact, they would stand to gain a great deal by it, as Chairman Cary said.

Mr. HARRIS. Do you see any substantial interference with the responsibilities and prerogatives of State commissioners in carrying out their duties on a State level?

Mr. FUNSTON. No, sir; I don't. I don't think there would be any conflict there at all.

Mr. HARRIS. You don't think there would be any encroachment on their prerogative?

Mr. FUNSTON. I heard the Chairman's answer in which he said that this was couched only in terms of their providing information which would be the type of information that would fit in with what they already accumulated and have at hand. If they issue securities they come under the SEC, anyway. No; I don't believe there would be an encroachment.

Mr. HARRIS. In making an analysis on the Special Study Group, in which you commented on the rules, you made the comment concerning chapter 8, relating to trading markets and the interrelationship between the exchange and over the counters that the legislation proposed by the Special Group would add 6,910 issuers to its reporting under the 1934 act. This is somewhat larger than the number of issuers which the Commission has testified would be involved in the proposal to bring these issuers of securities traded over the counter under the 1934 act.

I note that you still go further and say that this prospect list includes 163 companies which appear to meet New York Stock Exchange standards for listing. Then your study indicates that there are an additional 82 banks and insurance companies which appear eligible for listing. This makes a total, I believe, of some 245 that appear eligible under your present listing standards.

Just what does this eligibility of the 82 banks and insurance companies mean?

Mr. FUNSTON. Those would be companies that meet the size criteria for original listing on the exchange, which would be, in general, at least 1,500 round lot stockholders, earnings of at least $1 million a year after taxes for 3 years, at least 500,000 shares in the hands of the public.

They have to have the market value of their stock at $10 million. We figure that about 50 banks are of that size, about 32 insurance companies, and then our regular prospect list at the present time is 163.

That does not mean, however, that all of these meet other requirements which we have or would be willing to meet them, such as not having any nonvoting stock and agreeing to solicit proxies and all those matters. This is the total list.

Mr. HARRIS. Do you presently list bank stocks?

Mr. FUNSTON. No, sir. We have not been too successful in encouraging them. We have a number of bank holding companies listed, but not of banks themselves.

Mr. HARRIS. Would it be fair to ask if it is your intention to do so?

Mr. FUNSTON. We have been trying very hard, sir, for a long time. The big reason that is given by many banks is they say that they don't want to list and have to come under a new jurisdiction. But I think the Commission has very wisely made provision for that in the present bill which allows the Comptroller of the Currency to write the specifications, which I believe would remove many of the objections that the banks have toward listing. At least I hope it would.

Mr. HARRIS. Thank you very much, and again I want to thank you for your presence here today.

Mr. STAGGERS. Due to the lateness of the hour, we will just ask a few questions. In the case of insiders, in the course of the hearings on House Joint Resolution 438, certain questions were asked of you concerning the protection afforded investors by various rules of the ex-

change relating to positions in firms which members of the exchange might hold subject to the approval of the exchange, such as officers and directors of nonmember corporations.

In this connection, some discussion was had of several examples that were then currently in the press, with possible conflicts of interest, such as the Chrysler Corp., the Prudential Insurance Co., and the Union Oil Co.

Although in your listing of the rules you state the Commission has not commented upon your rule 318, I wonder whether you can tell us what you have done in this regard following these discussions of 2 years ago, if you have done anything at all.

Mr. FUNSTON. Sir, we have had a rule before then and still have that members have to report to the exchange any new directors or new boards that they are serving on if the corporation is in the securities business. I believe it was since then that we sent out an educational circular to all of the members, pointing out the things they have to be aware of and watch out for when they serve on a board of any kind, if it is a listed company or a nonlisted company.

We think we have sharpened up the definition of that. Could I look that up and write to you about it? To tell the truth, I can't exactly remember the context of what was said before, and I would like to make sure of that and write it and submit it to you for the record, if I may.

Mr. STAGGERS. You may, if you will.

(The following information was later received from Mr. Funston:)

NEW YORK STOCK EXCHANGE,
New York, N.Y., December 19, 1963.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: During my appearance before your committee at the hearings on H.R. 6789, you asked me what steps, if any, the exchange had taken recently with respect to our rule 318 concerning members' and allied members' connections with non-member business organizations. Since your question was prompted by our discussion 2 years ago when you were considering House Joint Resolution 438, you permitted me the opportunity to refresh my recollection and submit my answer in writing for the record.

Rule 318 states (among other things) that every member or allied member in a member organization must be actively engaged in the business of his organization and devote the major portion of his time thereto. In addition, without prior approval of the exchange, no individual member and no member or allied member in a member organization shall become a partner, officer, or employee of a nonmember business organization. However, exchange approval is unnecessary when a member or allied member becomes a director of a corporation not in the securities business.

In December 1961 we issued the enclosed Member Firms Educational Circular No. 152, part of which cautioned our member organizations on the possibility of problems arising from a member firm having a director on the board of a corporation and making an active over-the-counter market in the company's stock or holding such stock or options, or warrants in such stock. In June 1962 we issued another educational circular on this topic highlighting several problem areas we felt merited consideration whether or not a directorate is involved. A copy of this circular, No. 162, is also enclosed.

It has been the experience of some of our firms that disclosure of directorates or other insider relationships when recommending the purchase or sale of particular securities is a good means of avoiding difficulties in this area. This procedure was formally recommended when, in September, the Board of Governors amended rules 472 and 473 and adopted changes and additions to the supplementary material under rules 471, 472, and 473. The recommendation appears under paragraph 2474A on page 4 of the enclosed pamphlet.

Of course, when such disclosure is made, care should be taken to avoid exploiting the situation by implying that the recommendation is based on privileged information. For this reason, disclosure of directorates is treated as a recommendation rather than a requirement to be met in every instance.

We think members and allied members can and do perform a valuable function by serving as directors of nonmember business organizations. Nevertheless, we are mindful of the possible conflicts of interest and I believe these circulars and the supplementary material under our Rules are helpful in reaffirming some of the more important considerations to be kept in mind by those entering into such relationships.

In any event, I hope these brief comments and enclosed material answer your question satisfactorily. If there is anything further I can do, please let me know.

Sincerely yours,

G. KEITH FUNSTON.

[Member Firms Educational Circular No. 152]

NEW YORK STOCK EXCHANGE,
DEPARTMENT OF MEMBER FIRMS,
December 26, 1961.

To: Members, member firms, and member corporations.
Subject: Low priced securities—Underwriting compensation.

The contributions made to the general economy, to the public and to private industry by member organizations over a period of years through their underwriting activities are substantial. In recent years member underwriting of smaller companies, possibly offering their shares to the public for the first time, has provided a real service in raising necessary capital for almost unknown enterprises.

With the increased interest in public offerings of low priced securities, the exchange began about 2 years ago to examine the activities of its own membership in this specific underwriting field. Attention has been directed mostly toward the area of compensation which is not only sensitive, but also most susceptible to public misunderstanding.

The NASD has just issued a statement expressing its concern in connection with compensation to underwriters in the offering of securities of unseasoned companies. In its statement it is indicated that the association will review public offerings to determine whether the arrangements entered into in connection with the offerings are fair and consistent with just and equitable principles of trade.

The NASD notice sets forth the general areas in which its examination will be made, and the fact that a special committee of its board of governors has been created to undertake the review. Member organizations, of course, will quickly familiarize themselves with the statement and the procedures established under it.

In supplementing the NASD notice, the exchange recommends to its member organizations the following additional "rules of thumb":

1. Directorates: In the recent past a member organization that believed itself fully aware of the responsibilities inherent in the acceptance of a directorship, by a partner or employee, encountered unforeseen difficulties when other aspects were added to the relationship. In addition to the directorate, the firm participated actively in the after-market and held options to acquire the stock. The combination of insider knowledge available to the director, coupled with a dominant after-market activity and the fact the firm had options to acquire the stock at prices below the quoted market later placed the firm in the position of being unable to defend its actions from charges of manipulation. Usually the responsibilities of a director are clearcut and recognized by a member organization. What may not be as evident is that more than ordinary diligence is required when the director relationship is combined with options to acquire the security while dominant participation in the market by the firm may enhance the value of such options.

2. Strict observance of NASD's "insider participation" policy on all allocations of new offerings.

3. Avoidance of any tie-in sales of any nature, bearing in mind the SEC statements on this subject.

It is recognized that each securities offering is different and must be looked at on its own merits. Questions arising on any portion of this may be directed to the department of member firms, extensions 526, 638, or 510.

FRANK J. COYLE, *Director.*

[Member Firms Educational Circular No. 162]

NEW YORK STOCK EXCHANGE,
DEPARTMENT OF MEMBER FIRMS,
June 22, 1962.

Subject: Directorates—Security positions—Principal markets.

As part of Circular No. 152 issued in December 1961, the exchange cautioned member organizations on the problems created and conflicts of interest involved which may arise when a firm has a director on the board of a company, makes an active over-the-counter market in the company's stock or holds such stock, or options or warrants on the stock.

The exchange is fully aware of the important public service performed by member firm directors on the boards of corporations. This is particularly true in the case of a smaller growing company which has only recently done public financing for the first time and whose management may be unfamiliar with problems which may arise in the company's relations with its public shareholders.

In view of the widespread interest in this topic, it is felt that a general statement of several problem areas which may merit consideration whether or not a directorate is involved, together with a few suggestions, may be helpful to member organizations.

1. Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it. Not until there is full public disclosure of such data, particularly when the information might have a bearing on the market price of the securities, is a director released from the necessity of keeping information of this character to himself. Any director of a corporation who is a partner, officer, or employee of a member organization should recognize that his first responsibility in this area is to the corporation on whose board he serves. Thus, a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers, or his research or trading departments.

2. Problems may arise when a member firm, or its officers or partners as a group, or their employees, whether or not a directorate is involved, hold investment positions (as distinguished from trading postions) or unexercised options or warrants to purchase shares of a corporation and the firm issues any report or market letter that might be construed as a purchase recommendation of the shares. It has been the experience of some firms that full disclosure of any insider relationship and/or the substance of the positions can be a means of avoiding difficulties in this area. At the same time, the question is raised whether liquidation of any such position in the shares, options, or warrants should not be deferred until a reasonable interval elapses after the issuance of such report or letter in order to negative the inference that the report or letter was issued for the purpose of influencing the price.

3. Whether or not a member organization has a director on the board of a company, some important questions are raised if the organization makes a market as principal in a security in which the firm, its partners, officers, or employees have an investment position or hold options or warrants to purchase the same security. The extent and character of the firm's activity in the market must be governed by the applicable facts, and it may be that under some circumstances the existence of unexercised options or warrants or an investment position would raise doubts as to the advisability of making a market in the security as principal. At the same time, the holding of options, warrants, or an investment position may not present similar doubts so long as the making of the market has not been done in order to influence the price prior to or in conjunction with the possible distribution of the security. Moreover, the sale of any such securities may require a time interval, perhaps substantial, between the suspension of trading operations and the liquidation of a security position in the issue.

Member firms are urged to consult their counsel on problems in any of these areas.

It is important to recognize that member organization employees may serve as directors only at the convenience of their firms. Therefore, especially careful review of any such directorates should be made to be certain that clear-cut lines of responsibility are recognized by all concerned.

FRANK J. COYLE, *Director.*

NOTE.—Questions arising in connection with this circular may be directed to the Department of Member Firms, extension 526 or 638.

C-7527

NEW YORK STOCK EXCHANGE

PUBLIC RELATIONS AND
DEPARTMENT OF MEMBER FIRMS

September 19, 1963

To Members and Member Organizations:

The Board of Governors has amended Rules 472 and 473 and has adopted changes and additions to the supplementary material under Rules 471, 472 and 473, effective October 15, 1963.

The new material is underlined.

Communications with the Public

Advertising, Market Letters, Research Reports, Sales Literature, Radio, Television and Writing and Speaking Activities

(Rules and Policies Administered by Public Relations.)

¶ 2471 **Advertising**

Rule 471. Members and member organizations shall submit to the Exchange —before publication—all advertisements for approval of manner and form of presentation, unless the copy is in a general form previously approved.

Amendments.
March 20, 1958.

• • • ***Supplementary Material:***

.10 Information regarding advertising.—Routine advertisements in a general form previously approved do not have to be submitted to the Exchange. These include: (a) business cards; (b) announcements stating that specific unlisted securities are bought, sold and quoted; (c) announcements of dissolution; (d) approved firm or corporation formations; (e) approved partnership or stockholder changes; (f) approved new offices; or (g) approved employment of registered representatives.

Underwriting ads do not have to be submitted to the Exchange unless a member organization in advertising with a non-member wishes to identify itself in the ad as a member of the New York Stock Exchange.

All other advertisements should be submitted to Public Relations and Market Development, in duplicate, prior to publication. One copy will be returned with an indication of approval or suggested changes in manner or form of presentation.

.20 **Requirements administered by SEC for over-the-counter brokers and dealers.**—Unless an over-the-counter broker or dealer is registered with the Commission under Section 15(b) of the Securities Exchange Act (see law at ¶ 4453, and following), he may not advertise through the facilities of interstate commerce, except in the case of securities specifically exempted by Regulations §§ 240.15a-1 [¶ 4452], 240.15a-2 [¶ 4452A] and 240.15a-3 [¶ 4452B].

¶ 2472 Market Letters, Sales Literature, Research Reports and Writing Activities

Rule 472. Each market letter, research report and all sales literature prepared and issued by a member or member organization for general distribution to customers or the public shall be approved in advance by such member or by a general partner or a holder of voting stock in such organization. Market letters, sales literature and research reports which refer to the market or to specific companies or securities, listed or unlisted, shall be retained for at least three years by the member or member organization which prepared the material. The copies retained shall contain the name of the member, partner, or holder of voting stock approving its issuance and the name or names of the persons who prepared the material, and shall at all times within the three-year period be readily available.

Amendments.

October 20, 1955, effective November 1, 1955.

• • • ***Supplementary Material:***

.10 **Information regarding market letters, research reports and sales literature.**—The requirement for three-year retention of such material applies only to members and member organizations which prepared it for distribution.

The term "market letter" refers to any publication, printed or processed, which comments on the securities market or individual securities and is prepared for general distribution to the organization's customers or to the public. It also includes material on investment subjects prepared by a member or personnel of a member organization for publication in newspapers and periodicals.

The term "research report" refers to printed or processed analyses covering individual companies or industries.

The term "sales literature" refers to printed or processed material interpreting the facilities offered by a member organization or its personnel to the public, discussing the place of investment in an individual's financial planning, or calling attention to any market letter, research report or sales literature, which is prepared for and given general distribution.

Internal wires, memoranda and other written communications to branch offices or correspondent firms which refer to securities, industries or the market in general and which are shown or distributed to the public are subject to

these standards; internal sales communications to be used in making recommendations to customers are also subject to these standards. All such material should be approved in advance by a general partner or a holder of voting stock, or his authorized delegate, and retained by the firm for three years subject to review by the Exchange.

Internal wires and memoranda carrying flash news, or in response to specific inquiries are exempt from these standards. Wires marked "For Internal Use" or "Confidential" are also exempt if their distribution is actually internal. However, close supervision must be exercised to be sure that these communications are used only for internal purposes.

¶ 2473 Radio, Television, Telephone Reports

Rule 473. Members and member organizations desiring to broadcast New York Stock Exchange quotations in radio or television programs, or in public telephone market reports, or to make use of radio or television broadcasts for any business purpose, shall first obtain the consent of the Exchange by submitting an outline of the program and an example of the script to be used.

The text of all commercials, used on radio and television or in telephone reports, must be approved in advance by the Exchange. Program material (except lists of market quotations) used by members or member organizations on radio, television or public telephone market reports, or program material supplied to these media shall be retained by the firm for at least a year and be available to the Exchange upon request.

Amendents.

October 20, 1955, effective November 1, 1955.

• • • ***Supplementary Material:***

.10 **Information regarding radio, etc., reports.**—A single copy of the text of commercials and program material (except lists of quotations) sponsored or supplied by the membership on radio, television and telephone market reports will be adequate.

¶ 2474A Standards for Advertising, Market Letters, Sales Literature, Research Reports, Radio, Television and Writing Activities

• • • ***Supplementary Material:***

.10 **General.**—Truthfulness and good taste are the traditional standards of the Exchange community in any form of communication with the public. Rules can never take the place of good judgment in such communications. Under some circumstances what is left out may be just as important as what is included.

Member organizations, of course, can never overlook basic characteristics of investments—that prices can go down as well as up; that dividends can be cut, omitted or increased; that there is some degree of risk in any security; that investments can not be depended upon to produce a certain return in terms of purchasing power or in dollars.

In reviewing member organization material—as specified in Rules 471, 472 and 473—the New York Stock Exchange is concerned with the manner—or form—in which information and opinions are presented. The Exchange can not, of course, be responsible for the accuracy and completeness of factual information, nor the opinions of member organizations, in the material reviewed.

Some of the guideposts established by the Exchange for written communications with the public include:

(1) Recommendations. A recommendation (even though not labeled as a recommendation) must have a basis which can be substantiated as reasonable.

When recommending the purchase, sale or switch of specific securities, supporting information should be provided or offered.

The market price at the time the recommendation is made must be shown.

(2) Disclosure. When market letters, sales literature or research reports recommend the purchase or sale of a specific security, member organizations must disclose the following information, if such conditions exist:

(a) that the firm usually makes a market in the issue being recommended.

(b) that the member organization or its partners hold options in any securities of the recommended issuer.

(c) that some or all of the recommended securities are to be sold to or bought from customers on a principal basis by the member organization or its partners (unless covered by (a) above).

(d) that the member organization was manager or co-manager of the most recent public offering (within 3 years) of any securities of the recommended issuer.

It has been the experience of some firms that disclosure of directorates or other insider relationships is a good way of avoiding difficulties in this area. When such disclosure is made, however, the firm should be careful to avoid exploiting these relationships by implying that the recommendation is based directly or indirectly on privileged information.

(3) Past Recommendations. Material promoting past records of research recommendations, in connection with purchases or sales, is acceptable if it covers all of the following:

(a) At least a 1-year period.

(b) A list of all of the issues in a specific "universe"—or clearly definable area which can be fully isolated and circumscribed—recommended during the period. The list may be given or offered.

(c) The date and price of each recommendation at the recommendation date and at the end of the period or when sale was suggested, whichever is earlier.

(d) The number of issues recommended, the number that advanced and the number that declined, in the event a list is offered but not included in the material.

It must be made clear that—

(a) There is no implication in any such published record of comparable future performance or that a customer can't lose by following the firm's recommendations.

(b) The period covered was one of a generally rising market, if such is the case.

(c) If a record is averaged, or otherwise summarized, such results would have been obtained only if each issue had been purchased when recommended and then sold at the end of the period covered or when sale was recommended. The purchase price of a given number of shares—such as a round lot—of each of the recommended securities must be shown. Commissions must be mentioned.

If such a record is started and published, and publication is subsequently discontinued for any reason, resumption will be permitted only when the intervening period is included in the published record.

A file of all the original recommendations on which the record is based must be kept by the firm and be available to the Exchange on request for three years.

A statement in a market letter, for example, that a particular security was recommended at a specific price and is now selling at a higher price is unacceptable if the intent or the effect is to show the success of a past recommendation. In such a case, all of the above qualifications would have to be met.

(4) Testimonials. In using testimonials, the following points must be clearly stated in the body copy of the material:

(a) The testimonial may not be representative of the experience of other clients.

(b) The testimonial can not be indicative of future performance or success.

(c) If more than a nominal sum is paid, the fact that it is a paid testimonial must be indicated.

(d) If the testimonial concerns a technical aspect of investing, the person making the testimonial must have adequate knowledge and experience to form valid opinion.

(5) Projections and Predictions. Past records, charts, tables or other material can not, of course, be used to promise future profits or income from securities.

Projections and predictions should be clearly labeled as estimates. A reference to the bases of the estimates should be given or must be available on request.

(6) Periodic Investment. In mentioning the benefits of dollar-cost-averaging, it should be made clear that periodic purchases in a fixed dollar amount must be continued through fluctuations in the market price, that such a plan does not protect against loss in a declining market, and that the price at which the shares are sold must be more than their average cost, in order to realize a profit.

If the low cost of buying securities under any periodic investment plan is emphasized, it is important to state whether there are commissions for the purchase and sale.

In showing total value of prior investments including reinvested dividends, the amount of the reinvested dividends should be stated separately. Commissions, taxes or other costs should also be mentioned.

(7) **Language.** Statements which are promissory, exaggerated, flamboyant or contain unwarranted superlatives are to be avoided.

(8) **Comparisons.** Any comparison of one firm's service, personnel, facilities or charges with those of other firms must be factually supportable.

(9) **Claims for Research.** For purposes of these standards, investment research encompasses the organized collection and analysis of information obtained in oral or written form from primary or secondary sources, which is concerned with securities, industries, the market or the economy in general and has the purpose of assisting member organizations and their customers in evaluating securities.

A member organization which advertises or promotes its research services or capabilities must have a reasonable basis for any claims it makes.

A market letter, research report or similar publication should not carry a research department by-line, or by implication give the impression of originating within a research department, unless it did originate there.

(10) **Dating Reports.** All market letters, research reports and similar publications must be appropriately dated. Any significant information that is not reasonably current (usually not more than 6 months old—depending on the industry and circumstances) should be noted.

(11) **Identification of Sources.** A market letter or research report not prepared under the direct supervision of the research department of the distributing firm or its correspondent member organization should show the person (by name and appropriate title) or outside organization which prepared the material.

In distributing market letters or research reports prepared under the direct supervision of the research department of a correspondent member organization, the distributing firm should mention this fact, although it may not be necessary to identify the correspondent by name. (See ¶ 2440A.10)

Releases prepared and published by or for a corporate issuer or its public relations counsel and distributed by member organizations should be clearly identified as such.

(12) **Portfolio Analysis.** Portfolio Analysis is defined as the appraisal of an investor's present holdings of securities, individually and collectively, for the purpose of offering investment recommendations consistent with his stated objectives and general financial status.

Persons engaged in Portfolio Analysis should be adequately supervised and they should not undertake analysis which is not commensurate with their experience and training.

¶ 2474B Standards for Speaking Activities

(1) Prior consent must be obtained from a general partner or a holder of voting stock, or from a branch office manager acting for the partner or

voting stockholder responsible for the member organization's communications with the public, for each speech or lecture course. (For Exchange approval of outside speaking activities see rules 318 and 346.)

(2) The member organization assumes responsibility for the general content of each such speech or lecture.

(3) A log of all single talks and lecture series given by a member or member organization personnel should be kept by the member or member organization for at least three years for delivery to the Exchange upon request. The log should contain the following information for each speaking assignment: (a) the name of the sponsoring group, (b) its presiding officer (or program chairman) and his mailing address, (c) the subject discussed, (d) the date, (e) approximate attendance and (f) the speaker's name.

All talks and lecture courses by members and member organization personnel, whether represening their own firm or cooperating with other firms as Investors' Information Committees, should be conducted in an educational manner.

In talks and lectures sponsored by public or private groups, such as clubs, lodges, colleges, evening adult schools, community centers, libraries, employee organizations, military bases, and professional societies, members and member organization personnel should not recommend specific securities, industries, or methods of investing. In such talks, any sales literature supplied should be made available on a pick-up or request basis rather than by general distribution to the audience.

In talks and lectures sponsored by member organizations themselves, or in other lectures where it may be pertinent to discuss specific securities, industries, or methods of investing, speakers are to follow the Standards in paragraph 2474A.

When members or member organization personnel invite guest speakers to participate in speaking programs, the member or member organization assumes responsibility for the content and manner of presentation.

* * *

The Board of Governors has adopted changes and additions to the supplementary material in Para. 2440A.10(2), effective October 15, 1963.

The new material is underlined.

¶ 2440A Statistical and Investment Advisory Services

• • • ***Supplementary Material:***

.10 To whom furnished.—A member or member organization may furnish:

(1) . . .

(2) To another member or member organization or to a non-member customer who is a non-professional, statistical or investment advisory services

(A) prepared by the member or member organization, or

(B) prepared by others and reissued by the member or member organization.

The meaning of "statistical and investment advisory services" above is restricted to publications or services intended to aid professional or non-professional clients of member organizations in investment decisions concerning securities or commodities. All such publications or services must be clearly and prominently identified as being a publication or service of the original issuing member organization. (The name of the original issuing member organization may be omitted if the distributing member organization clears its listed business through the issuing member organization.)

* * *

The Board of Governors has amended Rule 346 and adopted additions to the supplementary material under Rules 318 and 346, effective October 15, 1963.

The new material is underlined.

¶ 2318 Other Connections of Members and Allied Members

Rule 318. Every member organization shall engage primarily in the transaction of business as broker or dealer in securities or commodities. With the prior approval of the Exchange, member organizations may engage in kindred activities.

Unless otherwise permitted by the Exchange every individual member must be actively engaged in the securities business and devote the major portion of his time thereto, and every member and allied member in a member organization must be actively engaged in the business of his organization and devote the major portion of his time thereto.

Without prior approval of the Exchange, no individual member and no member or allied member in a member organization shall become:

(1) A partner in any non-member business organization;

(2) an officer or employee of any non-member business corporation, firm or association;

(3) an employee of any firm or individual engaged in business; or

(4) associated with any outside securities, financial or kindred business.

Amendments.

December 19, 1955, effective January 4, 1956.
December 19, 1956, effective January 2, 1957.
April 21, 1960, effective May 2, 1960.

• • • ***Supplementary Material:***

.10 The Board of Governors has determined upon the following permissible exceptions:

(1) Director of corporation not in the securities business;

(2) chairman of a board of directors of a corporation not in the securities business;

(3) officer of personal holding company not publicly owned;

(4) officer of operating company not in the securities business, if duties are nominal and not operational;

(5) officer of an investment trust, open end or closed, if it is not self-managed and self-distributing;

(6) officer, for a reasonable period, of an operating company whose securities the firm underwrote, distributed or sponsored; and

(7) affiliations of members and allied members existing on December 31, 1956.

In respect of item (4) of Rule 318, above, the Board has determined that a financial interest in a securities or financial or kindred business, whether through stock ownership, or bonds, or loans of any nature, would constitute an "association", unless the ownership was nominal—not exceeding 5%—and the other securities or financial or kindred business were publicly owned.

The Board has determined that an individual member is "actively engaged in the securities business", as the phrase is used in Rule 318, when he is active as a Floor trader, specialist, so-called two dollar broker, or associated odd lot broker, or engaged in business with the public by servicing customers' accounts and introducing them to another member organization.

.11 Writing, Broadcasting and Speaking.—Policies pertaining to writing, broadcasting and speaking activities by members, allied members and other personnel of member organizations, are detailed in Supplementary Material to Rule 346 (¶ 2346) and under Rules 471, 472 and 473 (¶ 2471, 2472, 2473, 2474) and Supplementary Material.

Outside writing, broadcasting and speaking activities referred to in Rule 346 means activities other than those engaged in by a member, allied member or member organization in the conduct of his or its securities business.

¶ 2346 Employees—Fixed Duties

Rule 346. Every registered representative of a member or member organization shall devote his entire time during business hours to the business of the member or member organization employing him, and shall not at any time be engaged in any other business or be employed by any other corporation, firm or individual, or serve as an officer or director of another corporation without the prior consent of the Exchange.

No non-registered employee, without the prior approval of the Exchange, shall be engaged at any time in any other financial or securities or kindred business, or be connected by employment or otherwise (in any but a purely part-time clerical capacity which does not conflict with his normal duties and full-time hours of employment with his regular member organization employer) with any other corporation, firm or individual engaged in such business. For the purpose of this Rule, investment companies, investment trust management companies and investment advisors shall be considered to be engaged in the securities business.

• • • ***Supplementary Material:***

.10 Writing and Broadcasting.—Consent of the Exchange will not be required for outside writing or broadcasting activities by members, allied members and employees of member organizations, when all of the following conditions are met:

(1) The total number of articles or appearances by any one such person published or broadcast in any calendar year does not exceed four, or the media is in the nature of a trade publication addressed primarily

to persons or groups within the securities industry (such as the Analysts Journal or the Bulletin of the Association of Customers' Brokers).

(2) The subject is in the field of finance, any compensation is nominal, and the activity does not interfere with the performance of full-time duties for the member organizations.

(3) A member or member organization approves the activity and assumes responsibility for adherence to Exchange standards in articles or broadcasting scripts prepared by personnel of that organization, and for information supplied for such articles or broadcasts; a general partner or a holder of voting stock of the member organization assigned responsibilities in this area approves material prepared by an employee in advance of publication or broadcast.

(4) The author is identified with the material, and it is made clear that the author is associated with a securities firm.

(5) The article or broadcast is broadly educational.

The term "outside writing and broadcasting activities" refers to activities other than those engaged in by the member, allied member or employee of the member organization in the conduct of his or its securities business.

.11 **Permission for Writing and Broadcasting Activities.**—The Exchange may grant permission in individual cases for outside writing or broadcasting activities not meeting all conditions in ¶ 2346.10 above, upon application, where conditions in sub-paragraphs (2), (3) and (4) of ¶ 2346.10 are met, plus the following:

(1) The Exchange is satisfied that the nature of the commentary, the media and the audience are such that the author or broadcaster will continue to be identified in the public eye primarily as a member of the securities community, and will not become generally identified as a writer or broadcaster;

(2) in cases where the nature of the writing or broadcasting ceases to be broadly educational and tends more toward current commentary:

(a) in the case of broadcasts, no recommendations are made to buy, sell, switch or retain investments, whether labeled as such or not;

(b) in the case of articles, where recommendations may be made, they are clearly identified as those of the author or of the author's member organization, whose name shall be stated in that case;

(c) the Exchange is satisfied with the general format and purpose of the article or broadcast.

.12 **Speaking and Teaching Activities.**—Approval of the Exchange will not be required for single talks, courses or lecture series on investment subjects given by members, allied members and other member organization personnel as outside speaking activities before community groups and institutions, when all of the following conditions are met:

(1) Consent for each such talk or lecture has been given by a general partner or holder of voting stock, or by a branch office manager acting for the partner or voting stockholder in charge of speaking activities for the member organization;

(2) the member organization assumes responsibility for the general content of each talk or lecture and the speaker's educational approach;

(3) in the case of talks and lectures, no more than $25.00 is to be charged as admission, registration or tuition, or is to be paid to the speaker as a total fee by the sponsoring organization; in the case of courses at accredited colleges or universities, the charges and payment to the teacher are not more than the educational institution's normal fees and payments.

The term "outside speaking activities" refers to activities other than those engaged in by the member, allied member or employee of the organization in the conduct of his or its securities business.

.13 **Permission for Speaking Activities.**—In individual cases of outside speaking activities where fees may be greater than specified in sub-paragraph (3) of paragraph above, specific approval of the Exchange will be required.

.14 **Standards and Guideposts.**—All outside writing, broadcasting or speaking activities by members, allied members and other member organization personnel, whether requiring specific Exchange approval or not, must comply with standards established in Rules 471, 472 and 473 and in Supplementary Material to these Rules. Copy and clippings for articles, radio-TV scripts, and a log of all speaking engagements must be retained by the member or member organization for three years for delivery to the Exchange on request.

RUDDICK C. LAWRENCE
Vice President
Public Relations
FRANK J. COYLE
Vice President
Department of Member Firms

HOUSE OF REPRESENTATIVES,
Committee on Interstate and Foreign Commerce,
Washington, D.C., January 2, 1964.

MR. KEITH FUNSTON,
President, New York Stock Exchange,
New York, N.Y.

DEAR MR. FUNSTON: I appreciate your letter of December 19 commenting further upon your rule 318 concerning which you had been questioned during your testimony before the subcommittee on H.R. 6789. This is a helpful amplification of your answer to the questions last month.

The second paragraph of your letter, however, is somewhat confusing to me in that you state, "However, exchange approval is unnecessary when a member or allied member becomes a director of a corporation not in the securities business."

I have reread your testimony of 2 years ago on the questioning in connection with this rule 318 and have reread the rule itself, and thought that I had correctly understood that it required prior approval by the exchange whenever a member became an officer or an employee of a nonmember business organization and that "nonmember business organization" covered corporations not in the securities business.

I wish accordingly that you would clear up for me whether rule 318 has been changed or whether by definition "nonmember business organization" means only organizations engaged in the securities business.

In this connection, also, I note the testimony of President Etherington of the American Stock Exchange in which he states that their rules have been revised since the testimony was presented to us 2 years ago at the time you discussed rule 318, and that at the present time the exchange now requires prior approval of one of its members becoming an officer, employee, or director of a nonmember corporation regardless of whether or not it is in the securities business.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance.

NEW YORK STOCK EXCHANGE,
New York, N.Y., January 17, 1964.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: Thank you for writing in reply to my letter of December 19 and giving me an opportunity to clarify our application of rule 318 dealing members' and allied members' connections with nonmember business organizations.

Under paragraph (2) of rule 318 no member or allied member may become an officer or employee of a nonmember business corporation, firm, or association without prior approval of the exchange. A nonmember business corporation, firm, or association is an organization engaged in business—either securities or otherwise—but not a member of the exchange. Although a director is not an "officer or employee," paragraph (4) of the rule requires prior approval when a member or allied member becomes associated with any outside securities, financial or kindred business. Here the phrase "associated with" includes directorships.

Consequently, prior approval is required when a member or allied member becomes an officer or employee of a nonmember business organization or becomes a director of an organization in the securities business, such as a bank, but is unnecessary when he becomes a director of a corporation not in the securities business.

On a further reading of the transcript covering my testimony before your committee on November 20, 1963, I have noticed I mistakenly stated (on p. 354) that members must report to the exchange any directorships they accept. I knew at that time that my recollection of rule 318 was hazy and in my response asked if I could write you a clarifying letter. My letter of December 19 was intended to restate the requirements of the rule in this area and to make it clear that reporting to the exchange is not required in the case of members serving on the boards of directors of corporations not in the securities business.

We have not found it necessary to require reporting to the exchange or prior approval by the exchange when members or allied members serve on the boards of corporations not in the securities business. Such positions do not require a great deal of time and, consequently, are not in conflict with the requirement that every member shall be actively engaged in the securities business and devote the major portion of his time thereto.

In any event, I appreciate the opportunity to clarify our rule and I hope these brief comments will be helpful.

Sincerely,

G. KEITH FUNSTON.

Mr. STAGGERS. Another question I would like to ask. It is my impression that the study devotes considerable attention to the role of the floor trader and makes certain recommendations respecting the continuance of floor traders.

I think chapter 11 characterizes this trading as being a vestige of the former private club nature of the stock exchange and in general recommends that floor trading be prohibited. What is the exchange's position on floor trading and what is the exchange proposing to do about it?

Mr. FUNSTON. Our position is that the floor trader makes a valuable contribution to the liquidity of the market. We have a recent example I can cite where, on a given day about a month ago, when Martin-Marietta Co. were liquidating their position in Sperry Rand, I believe some 800,000 shares were sold that day, a stock that was selling at around 15 or 16, and they were all cleaned up when some 396,000 shares were transacted at very close to the last sale, and of that remaining 396,000 shares the floor traders took a sizable percentage of it.

We believe sincerely that the floor trader makes a real contribution. We have engaged, I think 6 weeks ago, Joel Dean, an economist of Columbia, who is well on his way, to study this matter and give us an

objective view of the rules that we have now, which we believe are quite restrictive.

When we get the report and study it out with him, then we will open discussions with the SEC.

Mr. Gray corrects me and reminds me that the man I mentioned, Joel Dean, is making a Specialist Study. It is Cresap, McCormick & Paget, a management consulting firm, that is making the floor trading study.

Out of this, we hope that we will be able to work out with the SEC a plan whereby they will agree, maybe with tighter restrictions than we have now, that the floor trader does provide a function and should be allowed to continue.

Mr. STAGGERS. I just wondered what your opinions were on the report concerning the floor trader.

Mr. FUNSTON. I don't agree with the views in the report.

Mr. STAGGERS. I just wondered what you were going to do about it.

Mr. FUNSTON. This is one of the priority items where as soon as we read the report we could see that it would be, and this is one of the items that the SEC picked for high priority, for us to work on, and we are working on it very actively.

Mr. STAGGERS. In relation to this Martin-Marietta stock being sold and your floor traders there, I would like to mention the fact that was brought up earlier about thin markets.

One of the great problems in maintaining a market in a given security is the fact of it being available, and so many of these institutions having them. How adequate are the rules for protection of investors in situations of this kind, either rules applicable to floor trading or rules applicable to disclosure of the amount of any issue that is outstanding in the hand of the public at large?

Mr. FUNSTON. With respect to the first point, everything is there on the record, all the transactions are there. That is the essence of the auction market, to give full price publicity and volume publicity. So it is all there in a goldfish bowl for everybody to see.

The second part of your question was, How much was available to the market?

Mr. STAGGERS. And the disclosure of the amount.

Mr. FUNSTON. I don't believe that we know or anybody knows the answer to that. We have a rule, of course, that to be listed, a company has to have at least 500,000 shares in the hands of the public, exconcentration of ownership.

So if it becomes apparent that there is a stock where there is not a sufficient outstanding supply, then we try, under our delisting rules to delist it.

Mr. STAGGERS. You have the power, then, to do something about it if there are these large transactions such as Martin-Marietta, and others?

Mr. FUNSTON. Yes, sir. Chairman Cary mentioned some special procedures we have for large block transactions, such as secondaries and special distributions, and so on. These are all controlled by the board of governors, when they are done in a listed stock by a member of the exchange.

We have no control over them when they are done by a nonmember in the so-called third market. There is no price publicity about that

at all. But when it is done through the exchange, we know all about it, there is no mystery about it, full information is made available.

In the Martin-Marietta thing, ordinarily a block that big you probably would have a special or a secondary. The trouble there is that it is much more costly to do it that way. So we try to encourage bringing it to the exchange, and in this case largely because of the help from the floor traders we were able to move this stock in 1 day on the regular auction market without having to resort to a secondary or a special.

Sometimes blocks of stock, large blocks of stock, in a listed security, that are handled off the board by nonmembers don't get the full price publicity.

In certain instances in the past those have caused us a lot of real problems.

Mr. STAGGERS. In relation to that, I believe there was one question that you recommended the number of sales in over-the-counter markets each day?

Mr. FUNSTON. Of listed stocks; yes, sir.

Mr. STAGGERS. Of the listed stocks?

Mr. FUNSTON. Yes; disclosure of price publicity, volume publicity for listed stocks which are traded in the over-the-counter markets.

Mr. STAGGERS. One of the big objections to the over-the-counter market is the wide spread of the price of asking and the price of bid.

Mr. FUNSTON. Yes, sir.

Mr. STAGGERS. I know that since these studies have gone into effect that that space has narrowed somewhat.

Mr. FUNSTON. I am not familiar with that, sir. That is another area that I have not been following very closely.

Mr. STAGGERS. It is a wide bid and wide ask.

I wish to again thank you for coming, Mr. Funston, for coming and giving us the benefit of your views.

Mr. Harris has a question to ask.

Mr. HARRIS. You may not be able to answer this, but it occurred to me it would be interesting. Would the stock of the Communications Satellite Corp. be eligible for listing on your exchange?

Mr. FUNSTON. Well, sir, we are having quiet discussions on that right now. I don't know. I can assure you that we will do everything that we possibly can if they meet the qualifications to list it. I think it is a great enterprise.

Mr. HARRIS. I think there is provision for limited voting stock, as you know.

Mr. FUNSTON. Yes, sir. I think that is a problem and we have been taking quite a strong stand on that. I don't know, though, we will have to look at it and see.

Mr. HARRIS. I think in view of the agreement that was reached at the International Telecommunications Conference recently, which I had the privilege of participating in for a few days, the corporation should be able to move ahead now. Thank you very much.

Mr. FUNSTON. Thank you.

Mr. STAGGERS. Again, thank you very much.

Mr. FUNSTON. Thank you, Mr. Chairman.

Mr. STAGGERS. The committee will stand in recess until tomorrow morning at 10 o'clock.

(Whereupon, at 4:32 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, November 21, 1963.)

INVESTOR PROTECTION

THURSDAY, NOVEMBER 21, 1963

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE OF THE
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room 1334, Longworth Building, Hon. Harley O. Staggers (chairman of the subcommittee) presiding.

Mr. STAGGERS. The subcommittee will be in order.

We are continuing our hearings on H.R. 6789, and we have as our first witness today Mr. James E. Day.

Will you state your name and position for the record, please, and start right in?

STATEMENT OF JAMES E. DAY, PRESIDENT, MIDWEST STOCK EXCHANGE; ACCOMPANIED BY CARL E. OGREN, VICE PRESIDENT, AND JOSEPH N. MORENCY, JR., COUNSEL, MIDWEST STOCK EXCHANGE

Mr. DAY. Thank you, Mr. Chairman.

My name is James Day. I am president of Midwest Stock Exchange, with Mr. Carl Ogren, executive vice president; and on my left, our counsel, Mr. Joseph Morency.

If I may, Mr. Chairman, I would like to suggest that the letter I received from Mr. Harris dated October 16, 1963, and our reply to him dated November 14, 1963, be made a matter of record.

Mr. STAGGERS. They will be.

Mr. DAY. I will read my statement, as it is rather brief.

(The letters mentioned follow:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C. October 16, 1963.

Mr. JAMES DAY,
Midwest Stock Exchange,
Chicago, Ill.

DEAR MR. DAY: As you know, the committee has before it H.R. 6789, which I introduced at the request of the Securities and Exchange Commission, and S. 1642, the companion bill, which has already passed the Senate, which embody legislative recommendations of the Commission growing out of the 2-year study it made pursuant to House Joint Resoultion 438, 87th Congress, into the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations.

As of this date, we have not yet set a date at which we will have hearings upon this proposed legislation, but it is my intention to have earnings thereupon when the schedule of the committee's activities so permits. I am sure

that you appreciate that inasmuch as the Commission's study was initiated and sponsored by this committee, the committee feels it incumbent upon it to consider this proposed legislation. At the time the legislation is considered, however, it is the committee's intention to review the recommendations of the Commission as to legislation and as to what should be done under rulemaking powers, and also as to the Commission's Special Study findings on the adequacy of the rules of the exchanges and of the securities associations for the protection of investors.

In this connection I am sure that you already have given attention to the Commission's expressions and to the findings of the Commission's Study Group with respect to the adequacy of the various rules which you have enunciated as well as to some which might be deemed appropriate to be promulgated.

I am writing this letter to you accordingly in anticipation of the hearings which we shall have on the legislation and the study, and of your appearance before the committee at that time expressing your opinion thereupon so as to make sure that you develop in your appearance, if not before that time, your analysis of all of your rules and the comments of the Commission and of the Study Group on each of your rules as to the adequacy of each rule, for the protection of investors, and the suggestions of what additional rules should be considered by you.

Sincerely yours,

OREN HARRIS, *Chairman.*

MIDWEST STOCK EXCHANGE,
Chicago, November 14, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
Longworth House Office Building, Washington, D.C.

DEAR MR. HARRIS: At your request, as contained in your letter of October 16, 1963, we submit herewith comments based on an analysis of our rules, a summary of the comments of the Special Study Group on the adequacy of such rules for protection of investors and their suggestions for the consideration of additional rules:

COMMENTS ON RULES

Our exchange and its predecessor exchanges have developed rules and regulations relative to the framework in which the exchange and its member organizations operate.

Our approach relative to rules and regulations is that in over 80 years of operation we have found public protection is not necessarily provided for by the adoption of innumerable rules and/or the accumulation of irrelevant and impractical data. We believe that, to be adopted at all, a law or rule must fulfill some proven need. Furthermore, we feel it will become effective in direct proportion to its acceptance and understanding. It is then the application and consistent enforcement of basic rules, regardless of the size or influence of those affected that produces the desired result. Proper qualification for entry into our business plus consistent application of rules is, in our judgment, the key to acceptance and effective investor protection.

To establish our point, we quote from the Special Market Study Release No. 34 of the Securities and Exchange Commission which provided a summary of the final segment of the study:

"The report describes the Midwest 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 * * *."

We are constantly in the process of evaluating our rules as to content and coverage with the view to initiating improvements based on past experience. We are now giving study to the SEC recommendations.

LEGISLATION

We have stated publicly that the proposed legislation as contained in H.R. 6789 and companion bill S. 1642 is good legislation which would add substantially to investor protection. The need for this type of legislation has been abundantly demonstrated and we support its passage.

STUDY

At your request, we provide the following comments on the Special Study Report itself. The report is a remarkable document which covers the broad spectrum of our industry. It has opened many areas for evalaution and has already prompted our industry to adopt many constructive practices. We have thus far given this study the serious attention it deserves, and we intend to continue to do so. We believe that as to which parts of the study can be adopted into rules and regulations can best be judged after the planned series of meetings between the industry and the SEC.

SPECIFIC RECOMMENDATIONS

We feel very strongly that it is impossible to give you reasonable or intelligent comment as far as innumerable specific recommendations are concerned and would not propose to do so until we have had sufficient time to study them and evaluate them individually.

Naturally, we have been considering the content of the study right from the time each portion was released. As you probably are aware, our staff is limited in size but, nevertheless, we have made every effort since receipt of your letter of October 16 to prepare the type of analysis requested.

We have divided our comments into two general categories. The first category consists of recommendations directed specifically to the MSE and our comments thereon. The second category contains those recommendations directed to subjects which would, if adopted, affect directly or indirectly the exchange and its member organizations and those recommendations directed specifically to some other agency but which may be applicable to our exchange. Our comments on recommendations in this second category have, of necessity, been limited to areas in which we felt remarks from us would make an appropriate contribution.

CATEGORY 1.—RECOMMENDATIONS DIRECTED SPECIFICALLY TO MSE

(1) *MSE supervision of selling practices.*—Recommendation No. 3 of chapter XII, section D, states that the MSE self-regulatory program devotes considerable effort to the enforcement of the net capital rule but seemingly inadequate attention to the supervision of member firm selling practices.

Presently, exchange auditors and officers examine the selling practices of member firms by various means. Other associations also examine our members, and this combined coverage, we believe, is adequate; but, as a result of the study comment, we are reevaluating our procedures.

(2) *MSE public advisers.*—Recommendation No. 2 of chapter XII, section D, directs the MSE to reassess the institution of public advisers to determine if they could be a more effective instrument for representation of the public in exchange affairs.

For many years our constitution has provided for the appointment of public advisers. They are not members of the exchange board of governors and they have no vote in any of its deliberations. We have not, nor do we wish to make, a voting member of our board anyone who is unfamiliar with our highly complex business, regardless of their achievement or stature in the business community generally. We would wish to retain them for the value of their counsel and advice in special situations involving broad questions of public policy, and not on technical matters.

CATEGORY 2.—RECOMMENDATIONS ON SUBJECTS INDIRECTLY AFFECTING MSE OR ITS MEMBER ORGANIZATIONS

(1) *Net capital.*—Recommendations Nos. 11 and 12 in chapter II, and recommendation No. 4 in chapter III, come under the general category of net capital. Article XX of the MSE rules requires member firms using the facilities of the clearing corporation, or doing business with the public, to maintain minimum net liquid capital of $25,000 or 6⅔ percent of its aggregate indebtedness, whichever is greater.

MSE has approximately 320 member organizations, 135 of which are also members of the New York Stock Exchange. In order to avoid duplication of effort, we rely primarily on the New York Stock Exchange's surveillance program of its members that are also members of our exchange. We do receive financial

information on these firms and watch very carefully the net capital situation of any firm that is a New York Stock Exchange member and also a registered specialist on our exchange. MSE is naturally the primary agency responsible for the net capital compliance of the 185 firms that are not members of another exchange.

The Special Study makes no specific recommendations for a change in MSE's net capital rules. No member organization solely a member of MSE has failed since the exchange was formed. No public investor has ever suffered a loss as a result of the failure of a sole member organization of MSE or its predecessor, the Chicago Stock Exchange. We think this is a positive indication of the adequacy of our rules and enforcement practices relative to net capital.

We have already gone on record in favor of net capital requirements for all those entering the business, and we are on record regarding the amounts and means of attaining these goals. This is now under study jointly with the SEC, and we think proper methods and amounts will be established.

(2) *Entry into the business.*—Recommendations Nos. 1 through 10, inclusive, in chapter II, deal with qualifications for entry into the business. Recommendation No. 1 treats with a subject that is part of the proposed legislation; i.e., the need for firms dealing with the public to belong to some regulatory body, and we have gone on record in support of it.

The remaining recommendations, although they do not directly pertain to our organization, are of great interest to us. We believe that this area is so broad that it requires a great deal of study. We do agree with the need for the improvement of qualifications and are willing to adopt any practical suggestions for improvement.

(3) *Selling practices.*—Chapter III, section B of the Special Study makes no specific recommendations for improvement or modification of MSE rules; however, it does outline a series of recommendations on selling practices.

There are certain areas which are not applicable to us but, generally speaking, we agree that every effort should be made to promote and increase full disclosure of all material facts and that sources of information should be disclosed as well as the name of the person responsible for the preparation of the data.

We further agree that every effort should be made to properly answer all investor complaints as well as those emanating from member firms who actually may be representing investors. In addition, we agree that all complaints should be kept in a single file and readily available for inspection by the SEC and other regulatory bodies.

On the other hand, we strongly oppose recommendations such as each order being marked "solicited" or "unsolicited" as being irrelevant and impractical. We would have the same negative reaction to recording so-called investment goals and, particularly, our opposition would be aimed at a so-called suitability rule. As a matter of fact, if we would single out the one recommendation which we believe to be the most harmful to our industry and the future liquidity of the marketplace, it would be the establishment of a suitability regulation.

Leaders of our industry, many of whom have been exposed to attempts in adopting suitability rules, and every attorney we have talked to are in unanimous agreement that such a rule borders on the impossible to define. Even if proper definition could be made, a broker acting in good faith on the basis of all known facts and exercising good judgment would have his action judged on the basis of subsequent events over which he had no control. To apply any penal provision or prohibition that cannot be clearly and comprehensively defined would leave an entire industry open to irresponsible lawsuits and unlimited liability.

(4) *Free credit balances.*—Recommendations Nos. 1, 2, 3, and 5 in chapter III, section D, direct that reserves on free credit balances be established and suggest that other rules be adopted regarding segregation and hypothecation of customers' securities. Our rules and procedures have been most effective, especially regarding funds on deposit. The record shows there have been no losses to customers of sole members of our exchange (those member firms over whom our own auditing department assumes sole responsibility). To the best of our knowledge, other exchanges have comparable records. In light of these facts, therefore, we see no justification for the recommendations when there is apparently no proof of need. Such proposals add costs to our business and obviously provide no additional, practical protection to investors. That phase of the recommendation which suggests that customers be given more frequent and more meaningful disclosure regarding free credit balances would be favored by our exchange provided the requirements and reports could be worked out on some practical basis.

(5) *Floor trading.*—Chapter VI, section F of the study proposes that floor trading be discontinued on the two eastern exchanges but suggests that insofar as regional exchanges are concerned the Commission ascertain to what extent this activity affects the market in sole listing on such exchanges.

Floor trading per se on MSE is so minute that restricting or stopping it would have little effect on our marketplace. This subject has been analyzed previously by the SEC, and the various studies indicate that there are areas where floor trading tends to accentuate market fluctuations rather than lend stability to the marketplace. It is our belief that there is merit in these conclusions; but, by the same token, we are convinced that floor traders do lend stabilizing influence when the entire market is considered as a whole.

We are strongly in favor of the NYSE's recent announcement of an independent study of this area and recommend that any proposed recommendations be held in abeyance until their study has been completed so that more careful consideration can be given to the pros and cons of floor trading.

We are exploring the possibilities contained in the suggestion regarding the establishment of auxiliary specialists. Our initial consideration indicates that this may prove to be a constructive supplement to our present procedure.

(6) *Specialists.*—Chapter VI, section D, deals with the Study Group's recommendations as to specialists' practices and regulatory concepts and methods to be adopted. Practically all recommendations deal specifically with the two eastern exchanges, and the only reference directly affecting MSE occurs in the first paragraph which states that studies are needed of regional specialists and no changes should be made pending such studies. We would be pleased to cooperate with the Commission in any objective studies regarding individual specialists or our specialist system.

After careful reading of the proposals outlined for the primary markets, we feel this is another area that requires detailed study and, as we understand it, the NYSE has started an independent analysis of this subject. Therefore, we would recommend that consideration of any rules or restrictive practices be held in abeyance until they have completed their study and there is an opportunity to further analyze the ultimate effect of proposed changes.

(7) *Short selling.*—Recommendation No. 3 in chapter VI, section H, relative to short sales is of direct concern to us. We believe the present rule is adequate, because short sales may be effected only on rising prices. At most, short selling has the effect of moderating a rise; and, in situations of excessive speculative activity, short sales may be doubly beneficial as they slow the rise as well as produce much sought after bids when long-selling pressure continues.

It has been our experience that in times of panic selling, the average investor either freezes into a long position or joins in the selling from fear. Therefore, the sophisticated short seller and the specialist are the major source of bids in situations where there could be a complete void under the market. For this reason, we believe that future studies of sales in an issue should also include an analysis of purchases to verify that covering short positions have a supporting effect.

(8) *Odd lots.*—Certain recommendations regarding odd lots are contained in chapter VI, section E and section I and chapter VIII, section B. These recommendations cover the cost and methods of handling odd lots, the odd-lot differential, as well as the regulation and surveillance of odd-lot dealers. Article XXV of our rules covers odd lots, odd-lot dealers, and the dual system. The Special Study makes no comment on our rules relative to odd lots. However, it recommends that the Commission and the regional exchanges study the methods and costs of handling odd-lot orders. We are willing to undertake such a cooperative study with the Commission on this subject.

With reference to recommendation No. 2 in chapter VI, section E (which states that the exchange should recognize and meet its responsibility in regulating odd-lot differentials) our exchange has always accepted that responsibility and will continue to do so; but any direct or indirect reference or proposal that the Government should set differentials or should evaluate profit levels would receive opposition from us. We are inalterably opposed to a Government agency setting a price for a service performed by private industry.

(9) *Commissions.*—Most of the recommendations on commissions as contained in chapters VI and VIII would have such a far-reaching effect that further extensive study is of utmost necessity. Generally speaking, we would oppose any recommendation for block discount. Such concessions would be completely arbitrary based in a principle that if the transaction is unusually large the customer is entitled to a reduced rate of commission. This logic could be carried to various

extremes, inasmuch as the size of the transaction is a relative condition. If there are inequities in the commission rate schedule, careful thought should be given to possible changes correcting such inequities through some form of readjustment of the commission rate structure and not by way of an indiscriminate allocation of what is known as block discounts.

The study, we believe, is lacking in effective support of this proposal. Studies of costs made by various concerns show that an increased rate would have to be charged on the smaller transaction if a discount were to be given on the larger or block transaction. In other words, as is true in so many other industries, the large transaction is carrying some of the basic costs of the smaller one.

It is further suggested that commission rates at present do not take into consideration nonmember professionals. We do not see any reason why they should. We are not in favor of associate memberships or any special nonmember rate. We do not share the study group's concern over reciprocity. It is presently controlled by this exchange. We believe if reciprocal arrangements are all properly reported to and supervised by a regulatory body such as the exchanges or NASD, they are a perfectly acceptable form of business arrangement.

We look with favor on the recommendation that a thorough study be made on the subject of the desirability and feasibility of a separate schedule of rates for basic brokers' functions and one for additional services that may be required by the customer, or a schedule of maximum rates or minimum rates covering all services.

(10) *Over-the-counter trading in listed securities.*—Reference is made by the Special Study in chapter VII, section F, to over-the-counter trading in listed securities as the "third market." Other references are made in chapter VIII, section D.

We have no objection to anyone's dealing in listed securities as an inherent right. However, where rules and regulations have been established through authority of Congress, we believe that they should be adhered to in all instances of dealing in a particularly designated class of securities.

The SEC proposes in the legislation now before you to eliminate the current double standard between listed and unlisted securities, especially as far as full disclosure is concerned. This will be at least the third attempt to correct a long-standing inequity.

Unless all those participating in the so-called third market are required to meet the rules and regulations applicable to the auction market in listed securities, the SEC will be sanctioning another double standard at a time when they are endeavoring to correct or prevent such conditions.

The so-called third market is permitted to trade in listed securities indiscriminately at any time without the responsibility for making a firm market on either the buy or sell side, with no specific requirements to keep records of volume, let alone prices and range and the publishing of such prices. No rules are defined for the filling of odd lots, no regulations as to short selling, just to name a few of the discrepancies that now make up an obvious double standard.

We believe that, in the absence of those regulations and requirements, consideration should be given toward restricting or prohibiting such trading in listed securities.

(11) *Regional exchanges* (Ch. VIII).—We believe that the Commission's policies on dual trading and unlisted trading has helped to promote the present position and future potential of the regional exchanges and that this policy has encouraged competition in the securities market.

In view of the fact that over 50 percent of the trading in all listed issues is confined to a relatively few (170 issues in 1961 and 171 issues in 1962) the need for regional trading in these large national issues to supply service to the public is obvious. Furthermore, since the daily volume on regional exchanges does run 80 percent or better in these large national dual issues, it is axiomatic that any limitation on dual trading would, for all practical purposes, eliminate even the major regional exchanges located in California, Illinois, Massachusetts, Michigan, Ohio, and Pennsylvania.

It has been alleged over a period of years that dual trading has, in some unproven fashion diluted the primary markets in these dual issues. The study group's conclusion in this regard is that the benefits of competition outweight any possible effects on the depth of (primary) existing markets.

Let it be noted that this merely reaffirms conclusions reached after a lengthy SEC hearing in 1940 wherein the then Commission said that there not only was no dilution in such trading but stated in paragraph 3, page 49, of the report: "It is quite possible that if the new business factor could be taken

quantitatively into account the volume of round-lot trading (in the primary market) would be shown to be enhanced rather than diminished as the result of the development of facilities for dual trading on local exchanges."

We wish to make clear that MSE believes that such dual trading should be on a carefully selected basis, confining such trading to those issues having an exceedingly broad and active market in the primary and, in turn, broad interest in the area of the local marketplace. It should be noted that dual trading under the so-called unlisted trading privilege, can only be secured through consent of the SEC following proof of interest within the local area. In addition, all parties concerned are notified of the trading request and permitted the opportunity to be heard. A significant percentage of dual trading involves issues fully listed on the Midwest Exchange, many of them listed on MSE before being listed on another exchange.

MSE believes that dual trading has several major advantages:

(1) It provides competitive markets and, as a direct result, gives the investor the opportunity to check more than one market. Basically, competition is as important in the marketplace as it is in any other form of business.

(2) Dual trading on regional exchanges permits the small broker-dealer throughout the Nation to fill orders for their clients in large national issues, thus more adequately serving the best interests of customers.

(3) The development of financial marketplaces in several sections of the country is economically sound, particularly when compared to a concentration in one single city.

(4) Dual trading on the regional exchanges creates a broader interest in listed securities and actually supplements and builds liquidity in the primary market.

(12) *Credit.*—Chapter X, section D, recommendations Nos. 1 through 5, deal with the extension of credit collateralized by over-the -counter and listed securities by broker-dealers, banks, and independent lenders. It would seem reasonable to us that the market liquidity of a security should control the percentage of credit permitted and that broker-dealers should be allowed to lend on over-the-counter securities which have liquid markets, on the same basis as is now permitted on listed stocks.

By the same token, it seems unreasonable to us that there should be unregulated lenders loaning on securities where the borrower uses the funds to purchase additional securities. This double standard of credit extension should be removed.

(13) *Automation.*—(Ch. XII, sec. B).—We have noted in our comments about previous chapters relative to the use of automation that we think there is a great future in this field, but having some experience, we know that the use of computers requires substantial capital investment as well as difficulty in acquiring people who really know how to operate them. We think that there are unlimited possibilities in the use of computers for surveillance of both listed and unlisted securities markets, specialists' activities and the processing of over-the-counter quotations. But we realize that there are fantastic costs involved in accomplishing the objective. As an example, our capital expenditures for setting up computers to do the accounting for 34 MSE member firms convinces us that the cost to set up computers for the processing of over-the-counter quotations nationally would mean an outlay of several millions of dollars.

Before any computers are put to work, we not only believe there should be a recognition of the substantial outlay of capital and the securing of proper talent to do the job, but highly recommend a thorough feasibility study to determine whether computers can do a specific job and at what price.

(14) *Disciplinary proceedings and due process.*—In chapter XII, section I, No. 5, the Special Study recommends that minimum requirements of due proces be observed in exchange disciplinary proceedings and in maters which may affect the right of specific nonmembers to do business with members; also, that certain types of exchange disciplinary matters be subject to review by the SEC.

Our rules governing discipline and trial proceedings (art. XXI) make adequate provision for notice, opportunity to be heard and review of penalties consistent with MSE's role as a self-governing voluntary membership association, this affording the protection of due process.

Control over officers, partners, employees, branch offices, private wire connections, and the character and fitness of applicants is an essential part of exchange supervision of member organizations. In these areas we make thorough inquiries and decisions of the staff are subject to review by the executive committee.

While the study finds no fault with our rules or practices in enforcement of them, nevertheless SEC review of exchange disciplinary actions is recommended.

We believe that self-regulation is a keystone in any business enterprise, and that it must be preserved with such refinements and improvements as may be deemed necessary. In order for it to be effective, the self-regulator must have the authority as well as the responsibility for his actions, and thus there should be no need for further review or oversight by a Government agency. Within the organization of our exchange there are the normal procedures of appeal and review of action taken by the president or by a committee.

In the area of actions by the exchange effecting nonmembers, such as persons seeking employment with member firms, prospective partners or officers of member organizations, or applicants for membership, the exchange must have the authority together with the responsibility of taking such definite and final action as it deems proper and necessary, even though due process may not be fully achieved in every instance, although it would be a rare exception. In any case where a nonmember may desire to make an appeal, we would be willing to provide for additional consideration to the nonmember concerned by setting up a "board of appeals" comprised of an equal member of nonadministrative persons of the exchange and nonmember advisers of the exchange (the latter representing other types of business).

In actual practice, we have never had an instance calling for such review, as every effort has been made to give the nonmember full opportunity to be heard, including a hearing before an exchange committee.

(15) *Self-regulation.*—Recommendation No. 1 in chapter XII, section D, directs that other recommendations of chapter XII may apply directly or with adaptation to the MSE.

We have examined the recommendations set forth in chapter XII and find that relatively few of these, even if adapted, apply to MSE. Of those few that do apply, we agree with some and disagree with others. For example, with reference to recommendation No. 3 in chapter XII, section B, directed to another exchange and covering floor surveillance, we are giving further authority to the officer in charge of the exchange floor. Recommendation No. 4, which calls for increased use of automation in surveillance, is agreed to in general. We are presently utilizing, to some degree, electronic data processing machinery in floor surveillance, and there is probably room for more intensive use in the future. But this machinery is costly, and the people who can make it work are hard to come by. We will necessarily proceed slowly.

Recommendation No. 3 of chapter XII, section I, directs a reexamination of exchange rules in light of changing circumstances and recommends a requirement be established that each new exchange rule be filed with the Commission 30 days in advance for the SEC's preeffective examination of said rule.

MSE makes periodic reviews of its rules. Rule changes are adopted by the board of governors of the exchange whenever they are deemed proper and necessary to meet changing conditions. We do not see the necessity for the SEC to have direct oversight and preeffective examination of rules. However, this is an area in which we are presently engaged in discussion with the SEC and, although we know many good, practical reasons why such a requirement should not be established, we will try to keep an open mind on the subject in discussing it with the Commission.

Recommendation No. 5 in chapter XII, section B, although directed primarily at another exchange, does nonetheless call for a reorientation in the handling of customers' complaints. It states that the exchange should act in a self-regulatory role and not in a protective role toward its members. We at MSE do not feel that there is any inconsistency between an exchange operating as a self-regulatory body and, at appropriate times, as a protector of its members. We believe that this exchange has always properly disciplined its members relative to customers' complaints. We feel that we have acted swiftly and conclusively on those complaints received from customers. We have found, after investigation, many instances where customers' complaints have been unsubstantiated; and in such cases we have, in our opinion, properly defended our members. Our years of experience have indicated that although "the customer is always right" he might not always be as right as he thinks he is or as he presents himself to be to a regulatory agency.

(16) *Specialist*—(ch. VI, sec. D).—Recommendation No. 7 of this section would require that the specialist be prohibited from serving public customers. We cannot agree with the Special Study recommendation that proposes specialists be

prohibited from servicing the accounts of public customers. MSE, in order to attract more capital to its specialist books, has made extended efforts over the last 15 years to attract member firms who serve the public to act as specialists. We have substantially increased the risk capital now available on our floor. We do not believe that the Special Study has proven the need for such a rule. All that appears to have been done is to cast a question of doubt as to the integrity of member firms on a purely theoretical basis. Any such rule would adversely affect the markets on the Midwest Stock Exchange, its members and member firms and our public customers.

We are attaching a copy of our constitution and rules rather than making specific citation in the body of the letter.

Respectfully submitted.

JAMES E. DAY, *President.*

Mr. DAY. The Midwest Stock Exchange, of which I am president, wishes to go on record as endorsing and approving the principles contained in H.R. 6789.

Our exchange does so because this bill will require unlisted companies whose securities have the broadest public interest to adopt the same fundamental safeguards that have been required of listed securities, in addition to its other constructive recommendations. The most important of these are:

1. Periodic reporting: The public is entitled to have as much information about financial affairs of larger companies whose securities are traded over the counter as they now obtain from listed companies.

2. Proxy solicitation: Again, this is a major step toward full disclosure to the investing public in three important ways: (*a*) Over-the-counter companies having the broadest public interest will be required to abide by the existing proxy rules and regulations now applicable to listed companies when a proxy solicitation is made; (*b*) if no proxy solicitation is made, these companies will still have to supply as much information to stockholders as they would if proxies were solicited; and (*c*) it will require brokers and dealers holding securities in street names to be more diligent in submitting proxies than has been the practice.

3. Insider trading restrictions: This section applies the same requirements to unlisted securities as to listed, such as officers, directors, and 10-percent holders having to report their holdings and transactions in equity securities and prohibiting insiders from making short sales. Furthermore, it allows the company to recapture any profits taken within the 6-month period by insiders.

The bill asks for disclosure of material contracts when applying for listing. In doing so, it quite properly defers the effective date for a reasonable period in order to give companies an opportunity to determine which contracts must be filed.

In addition, H.R. 6789 seeks to strengthen entrance standards into the securities business and requires that brokers and dealers, in most cases, be a member of at least one self-regulatory group, such as the NASD, unless exempted by the SEC. Additional steps would be taken to control the caliber of persons in the securities business, whether newcomers or veterans.

There is special treatment in the bill regarding banks and insurance companies. For example, it permits the administration of its provisions by appropriate Federal banking regulatory authority, rather than by the SEC. In this we concur.

H.R. 6789 also wisely recommends that the period during which a broker or dealer is required to deliver a prospectus to each purchaser in cases involving a company's first registered offering of securities to the public be extended to 90 days from the present 40. This should serve to cool off the so-called "hot" issues, to some extent. It is also suggested that the 40-day period may be too long in cases of the offering of additional securities and proposes that the SEC be empowered to reduce this period where appropriate.

Overall, we believe the main effect of the bill is in the area of full disclosure for all publicly held companies having the broadest public interest, whether listed or unlisted. The SEC has called full disclosure the keystone to its entire program with relation to the investing public.

In approving this bill, the Midwest Stock Exchange has taken no new position, since we have looked with favor in the past on similar bills dealing with the same fundamentals, such as the Frear and Fulbright bills.

With reference to the earlier bills, it is unfortunate that certain minority groups succeeded in sidetracking the legislation; for, to the best of our knowledge, the vast majority of our industry approved those bills, and we believe are in favor of H.R. 6789.

The only objection we have heard with regard to this bill is the question of additional costs to be incurred by small and medium-sized companies. Along this line, members of the Midwest Stock Exchange staff surveyed law and accounting firms seeking an opinion.

We checked four outstanding legal organizations which, to our knowledge, handle the bulk of securities work in the city of Chicago and found them to be surprisingly uniform in their estimates of what the cost increases might be, ranging from 10 to 15 percent of present legal fees. The accounting firm estimates ran from 10 to 20 percent, based on the assumption, however, that the firms were now receiving annually a regular CPA audit.

Putting the two together, we found that dollarwise, additional fees for the smaller firms should not run more than $1,500 to $2,000, except in the most unusual cases. For many of the firms now using legal counsel for tax purposes and receiving regular CPA audits, fees might run only $500 more than they are now paying.

We can only conclude that the argument that has been expressed about tremendously increased costs to smaller firms is contrary to fact.

Once again, let me say that H.R. 6789 is a good bill, in our opinion, and we endorse it and recommend it to the Committee on Interstate and Foreign Commerce of the House of Representatives.

Mr. STAGGERS. Thank you, Mr. Day.

Does either one of the gentlemen with you have a statement they wish to make at this time?

Mr. DAY. No, sir; not at the moment.

Mr. STAGGERS. The committee is appreciative of your testimony, since yours was one of the exchanges which was included in the Special Study by the Commission. We are alse appreciative of the time and effort which you put into your reply to the October 16 request by Chairman Harris for an indication as to each of your rules, what the Special Study group had to say, and what position the Commission had taken.

I believe your answer is not fully responsive to all of those questions.

Mr. DAY. Mr. Chairman, I agree with you. When we received this letter, we called Dr. Stevenson. We were a little nonplussed here because in the short time required or given us, plus the small staff that we had, this was an almost impossible job for us.

All I can say to you, sir, is that we did the best job we could do and we were as frank and honest as we could be with your committee.

Mr. STAGGERS. I wonder if you wish to amend that with a further reply?

Mr. Day. If given the time, we would be very happy to do that, Mr. Chairman.

Mr. STAGGERS. You will have the time. We will see that time is extended to you because we want to make the record complete. We would like to have each organization under the Study Group reply in full on all of the questions.

Mr. DAY. Thank you for giving us the time. We will be happy to do it.

(The following material was received in response to the above requests:)

SUPPLEMENTARY REPLY BY MIDWEST STOCK EXCHANGE, CHICAGO, TO LETTER DATED NOVEMBER 14, 1963, ADDRESSED TO HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

ANALYSIS OF THE RULES OF MIDWEST STOCK EXCHANGE

Article I. Membership

Rule 1. Provides for certain basic requirements of membership.

Rule 2. Capital requirements for admission to membership of individuals and firms.

Rule 3. Definition of membership and a member's vested rights in liquidation.

Rule 4. Procedure for the filing and processing of an application for membership.

Rule 5. Sets amount of fee for transfer of membership.

Rule 6. Requirement of new member to pledge compliance to constitution and rules of the exchange, including pledge of partners, officers and directors.

Rule 7. Designation of a partner or officer of a member firm as the exchange member nominee.

Rule 8. Requires announcement of proposed transfer of membership before final action.

Rule 9. Exchange membership held by a partner or officer requires registration of such firm as a member firm or member corporation. Failure to register requires such member to withdraw from firm or dispose of membership.

Rule 10. Secretary of the exchange may assist in arranging for the purchase and sale of memberships.

Rule 11. States the status of a membership pending transfer.

Rule 12. Conditions under which president of exchange is directed to sell a membership.

Rule 13. Restricts member activity after announcement of proposed transfer of membership.

Rule 14. Sets date of settlement of open contracts of a withdrawing member.

Rule 15. Stipulates priority of payment of proceeds on sale of membership.

Rule 16. States that exchange rules supercede any document of member providing for transfer of interest or proceeds of sale of membership which may be contrary to exchange regulations.

Rule 17. Permits retention of all or portion of proceeds of sale of membership pending final determination of amounts in question.

SEC Study Group comments.—Observes that all exchanges impose requirements on their member firms relating to competence and integrity of their principals and the financial capacity of such firms. These requirements, in the case of Midwest, are applied to those firms which are not also members of New York

Stock Exchange. While these requirements are not formally stated, exchanges such as Midwest impose controls over the character and business reputation of their member firms.

Quoting directly from the study: "At the Midwest Stock Exchange, for some years, new 'Midwest only' members or new partner of old 'Midwest only' firms who, in the judgment of the exchange, did not have sufficient experience, have been required to undertake further training and pass an examination. * * * Its floor broker examination appears to have the first such competence requirement instituted by an exchange."

SEC recommendation.—Regulatory and ethical standards should receive greater emphasis in training and examination programs of the self-regulatory agencies.

Exchange comment.—The Special Study comments and recommendations are primarily directed to "character and fitness" qualifications for entry into the business, and adequate experience and training for persons engaged in selling or as managers. The above exchange rules deal with admission to membership, and as such, are applicable to persons and firms who have had experience in the securities business. Character and integrity of all applicants is an essential qualification which our investigations and inquiries seek to establish.

Article II. Elections

Rule 1. Sets the hours and other details for election of members of the board of governors and other member officers in which the entire membership participates.

Rule 2. Composition of the committee on elections.

Rule 3. Operating procedures of the nominating committee.

Rule 4. Procedure in the event of a tie vote.

Article III. Committees.

Rule 1. Committee appointments made by chairman with approval of Board of governors; chairman also designates chairman and vice chairman.

Rule 2. Provides for regional committees in Cleveland, Minneapolis-St. Paul, and St. Louis, advisory to manager of exchange branch office in such cities. (No office maintained in Minneapolis-St. Paul.)

Rule 3. Provides for investment committee to carry out the general investment policy of the exchange with the required employment of professional investment councelor.

Rule 4. Provides for finance committee to prepare annual budget and to recommend membership dues and other charges; general supervision of financial operations of the exchange.

Rule 5. Provides for committee on public relations; advisory to the President.

Rule 6. Provides for committee on floor procedure having general supervision of conduct and dealings on the trading floor; responsibility to appoint specialists and odd lot dealers.

Rule 7. Provides for an admissions committee to consider and recommend applicants for membership.

Rule 8. Provides for appointment of a judiciary committee to conduct trials of members if so requested or to hear appeals on penalties imposed by president.

Rule 9. States manner in which committees shall function.

Rule 10. Quorum requirement of the board.

Rule 11. Quorum requirement of committees.

Article IV. Making exchange contracts.

Rule 1. Applicability of rules to exchange contracts.

Rule 2. Prescribes conditions for settlement of contracts on a business day when banks and transfer agents are closed.

Rule 3. Restricts dealings on the exchange to the hours prescribed by the board.

Rule 4. Restricts dealings to securities admitted on an "issue," when issued," "when disrtibuted," or "unlisted trading" basis.

Rule 5. Restricts dealings on floor of exchange to "member to member" or with an exchange officer or employee authorized to execute contracts "under the rule."

Rule 6. Prescribes unit of trading as 100 shares or such amount as set by the committee on floor procedure.

Rule 7. Prescribes unit of trading in "rights."

Rule 8. Quotations represent bids and offers of a trading unit or multiple.

Rule 9. Pertain to bids and offers in "when issued" dealings.

Rule 10. Provides for bids and offers in contracts for "cash," "regular way," and "sellers option."

Rule 11. Requirement that bids and offers be audibly made at the post.

Rule 12. Provides for securities having a unit of trading of less than 100 shares to be dealt in at a cabinet system and prescribes procedures.

Rule 13. All bids and offers made and accepted are binding.

Rule 14. Bids and offers for amount greater than unit of trading shall be for such amount on any lesser number of trading units.

Rule 15. When bid or offer is established, a lower bid or higher offer cannot be made.

Rule 16. Highest bid has precedence in all cases.

Rule 17. Procedure for determining priority and precedence when bids are made at the same price.

Rule 18. Lowest offer has precedence in all cases.

Rule 19. Procedure for determining priority and procedure where offers are made at the same price.

Rule 20. Precedence on "sellers options."

Rule 21. Conditions necessary to establish claim for best bid or offer.

Rule 22. Disputes relating to bids and offers settled by members or committee on floor procedure.

Rule 23. Regulates fractional price variations at which stock may be quoted.

Rule 24. States procedure where member has orders to buy and sell the same security.

Rule 25. Prescribes length of time certain floor records must be retained, including orders originated by the floor member and orders received by him from a nonmember.

Rule 26. Miscellaneous restrictions applicable to floor members.

Rule 27. Prohibits placing of orders with two or more floor brokers of market orders in the same security for the same principal.

Rule 28. Restricts publicizing names of bidders or offerors or buyers or sellers to certain situations.

Rule 29. Gives definition of an agreement by a member to "stop" securities at a certain price.

Rules 30. Prohibits prearranged trades.

Rule. 31. Every bid or offer for another member shall be supported by a written order.

Rule 32. Provides for reduction of bids and offers when an issue is quoted "ex dividend" or "ex rights."

Rule 33. Power of committee on floor procedure to regulate unusual market situations.

SEC comment and recommendations, relating to round lots (rule 6, art. IV).—A reduction in the round-lot trading unit would tend to add to the flow of buy and sell orders constituting the depth of the market and should receive consideration for all or some securities.

Exchange comments.—In issues listed only on Midwest, the round-lot trading unit is in most instances, 100 shares, but where it appears that a lower unit of trading would contribute toward a "market of greater depth" a unit of 50, 25, or 10 shares may be applied. In a number of smaller issues, the unit of trading is 1 share, permitting all buyers and sellers to negotiate with complete flexibility. Notwithstanding this flexibility, the exchange does not accept the premise that in all situations a lowering of the unit of trade would, per se, give the market greater depth. The conditions of each issue would necessitate seprate consideration.

Article V. Exchange of contracts, tickets, and comparisons

Rule 1. Requires prompt reporting of transactions by members.

Rule 2. Requirement for member offices to remain open to such hour as necessary for completion of comparison of transactions.

Rule 3. Duty of seller to initiate comparison of transaction with buyer each hour.

Rule 4. Comparison of transactions shall conform to rules of clearing corporaporation.

Rules 5 and 6. Procedure for following through on "don't know" trades (trades where buyer and seller records are not in agreement).

Rule 7. Duty of buyer to investigate prior to 10 a.m. of following day on trades not compared.

Rule 8. Time limit on comparison of special situations.

Rule 9. Procedure and time limits for giving up of other member names on transactions; responsibility of firm given up.

Rule 10. Duty to record immediately names of given up firms.

Rule 11. Neglect to make comparison of trade constitutes a default.

Rule 12. Contracts not completed on settlement day, subject to "fail" confirmation by either party.

Rule 13. Comparison of transactions or failure to compare shall have the effect of creating or canceling a contract.

Rule 14. Orders for receipt and delivery by clearing corporation binding upon members.

Article VI. Settlement of exchange contracts

Rule 1 through 35. Deal with the technicalities and mechanics of "settlement of exchange contracts."

Article VII. Reclamations

Rule 1 through 8. Provide for reclamations on items being settled between members having some condition of irregularity.

Article VIII. Loans of securities

Rule 1 through 5. Terms and conditions under which securities may be loaned.

Article IX. Closing contracts

Rule 1 through 13. States conditions and procedures by which contracts may be closed "under the rule."

Article X. Marking to the market

Rule 1 through 3. Authorizes party to a contract to demand deposit of additional funds where an open contract between members becomes partially secured due to change in market conditions.

Rule 4. Failure to provide additional funds permits contract to be closed "under the rule."

Article XI. Dividends, interest, rights, and due bills

Rule 1 through 10. Prescribes procedures for transactions involving ex-dividends or ex-rights; the use of due bills.

Rule 11. Due bills for stocks, rights, or warrants redeemable upon presentation; if not redeemed, may be closed out "under the rule."

Article XII. Access to and communication with the floor; teletype and wire regulations

Rule 1. Visitors not permitted on trading floor without permission of member of floor procedure committee or exchange officer.

Rule 2. Communications or announcements on the floor not permitted without president's consent or of person designated by him.

Rule 3. Trading floor employees of members must be approved and registered by the exchange.

Rule 4. Requires approval for private telephone or wire connection to exchange floor. Authorizes exchange to terminate such facility. May deprive use to a member of any such facility installed by the exchange.

Rule 5. Wire communications between exchange and exchange branch offices operated and controlled by the exchange and its employees.

Article XIII. Insolvency

Rule 1. Obligates member to inform the exchange of its inability to meet its contracts; provides for immediate suspension from membership.

Rule 2. Gives president authority to suspend a member who has failed to perform his contracts or where it appears that a member cannot continue to operate with safety to his creditors.

Rule 3. Suspended member required to cooperate toward full investigation and submit list of all creditors.

Rule 4. A suspended member who fails to settle with all creditors within 1 year, or fails to obtain reinstatement shall cease to be a member and membership shall be sold.

Rule 5. Outlines procedures and requirements for reinstatement.

Rule 6. Where suspended member is also guilty of irregularities or unbusinesslike dealings, he may be declared ineligible for reinstatement.

Rule 7. Member under suspension may be charged with other rule violations.

Rule 8. Suspension for financial reasons deprives member of all rights and privileges of membership, except if suspended for insolvency, any remaining transactions may be serviced at member commission rates.

Article XIV. Member firms.

Rule 1. A partnership may become a registered member firm by direct acquisition of membership or by application of an exchange member who becomes a general partner.

Rule 2. Advance written notice required of withdrawal of member partner or dissolution of firm.

Rule 3. Registered firm must be active in the securities business.

Rule 4. Partnership articles to be submitted to exchange.

Rule 5. Provides that proceeds from sale of membership be available for protection of creditors.

Rule 6. Claims of partners are subordinate to claims of others.

Rule 7. General partners must have a fixed interest in entire operation of firm.

Rule 8. Partner may not encumber his interest in a firm without prior consent of exchange.

Rule 9. Firm must have minimum of two general partners.

Rule 10. Prohibits a partner from being a partner in more than one firm, or an officer, director or stockholder of a member corporation.

Rule 11. Any member being a partner in a securities firm must register such with the exchange.

Rule 12. A member partner must devote major portion of time to the firm.

Rule 13. Extension of membership privileges to firm on death of member partner.

Rule 14. Prohibits formation of a member firm with a suspended or expelled member or insolvent person.

Rule 15. Membership held by a limited partner does not confer membership to the firm.

Rule 16. Exchange may terminate registration of a member firm.

Rule 17. Requires member firm to designate a "nominee" among the general partners as the individual member.

Article XV. Member corporations

Rule 1. Authority for registration of a corporation as a member corporation.

Rule 2. Principal corporate purpose must be the securities business.

Rule 3. Corporate form may not be used to evade financial responsibilities. Claims of directors, officers, and principal stockholders subordinate to others.

Rules 4 and 5. Application filing requirements.

Rule 6. The exchange member officer of a member corporation must be the president or vice president.

Rule 7. Banks or subsidiaries, trust companies, investment companies ineligible for membership.

Rule 8. Percentage of stockownership by management.

Rule 9. Prohibits affiliation with another firm in the securities business, except with exchange approval.

Rule 10. Holders of 10 percent or more of stock shall not pledge or hypothecate without notice to exchange.

Rule 11. Membership privileges may be extended to the corporation on death of member officer.

Rule 12. Only member officer may use facilities of exchange trading floor.

Rule 13. Notice required of commitment in a single issue exceeding 70 percent of member corporation's capital and where held for more than 3 days.

Rule 14. Loans to corporate officers must be reported to the exchange.

Rule 15. Registration of a member corporation may be terminated by the exchange.

Rule 16. Nothing contained in member's articles of incorporation, etc., is binding on the exchange.

Article XVI. Partners, officers and directors, branch managers, employees, wire connections, office arrangements

Rule 1. Provides for exchange jurisdiction over nonmember partners of member firms.

Rule 2. Requires registration of managers of members' branch offices.

Rule 3. Provides that exchange may require registration of sales personnel, or other employees of member firms, private wire connections, and office sharing arrangements. Written disapproval of any of the foregoing requires discontinuance. Notice to exchange required of termination of registered employees of member firms.

Rule 4. Regulates amount of commission that can be earned on business in which salesman has a personal interest.

Rule 5. Floor members may not be employed as floor clerks.

Rule 6. Rightof exchange to withhold or withdraw approval of registration of employees of member firms.

SEC Study Group recommendation.—Standards for individuals' entry into the business should encompass (a) competence, in the sense of knowledge and experience; and (b) character and integrity.

Examination for determining competence should be improved, refined and coordinated; appropriate experience requirements should be adopted for individuals in crucial roles.

Character and fitness of persons in the securities business of most importance; initial responsibility lies within each firm, but effective enforcement is the obligation of self-regulatory agencies.

MSE comment.—For a number of years, Midwest has applied the above three categories of qualifications to individuals comprising salesmen, branch office managers, partners or officers of member firms and member corporations. Steps have been taken recently to coordinate examinations and examination procedures with those of the New York and American Stock Exchanges and NASD. Experience is a definite requirement for persons in position of responsibility who are subject to exchange approval. Character and integrity of persons subject to exchange approval are primary conditions of acceptance under all circumstances. Midwest will continue to review procedures and requirements in these areas and will make such changes as are deemed essential on the basis of experience and study.

Article XVII. Business conduct

Rules 1–14. Recital of prohibitions in conduct of a member, member firm or member corporation; provides that a willful violation of the Securities Exchange Act of 1934 or the rules and regulations thereunder shall be considered conduct inconsistent with just and equitable principles of trade. Prohibits any act detrimental to the interest or welfare of the exchange or inconsistent with just and equitable principles of trade.

Article XVIII. Trading rules

Rule 1. Prohibits members' excessive trading in relation to financial resources or condition of market.

Rule 2. Approval required for effecting transaction on the floor in which the member or his firm have an interest, except joint account, and Specialist-Odd lot dealer transactions.

Rule 3. Requires approval of and reporting of joint account activities.

Rule 4. Prohibits handling discretionary orders on the floor, except as specified; prohibits excessive activity in discretionary accounts.

Rule 5. Prohibits dealings for own account which having unexecuted orders for customers, except as provided.

Rule 6. Prohibits effecting of transactions for the purpose of creating artificial appearance of activity or for improperly influencing the market.

Rule 7. Prohibits dealings in stocks in which member or his firm hold or have granted an option.

Rule 8. Record retention requirement of orders transmitted to the floor, orders originated on floor.

Rule 9. Procedure for effecting a "buy" and "sell" transaction in which the member is a principal.

Rule 10. Specifies the time the exchange is open for business.

SEC Study Group comment.—On the broad general subject of floor trading activities, a proposal is made to abolish floor trading. Suggests statement of policy relating to "approved and disapproved practices in the handling of discretionary accounts."

MSE comment.—Floor trading on Midwest by so-called professional floor traders is practically nonexistent; the exchange, therefore, has no rules or regulations in this regard, nor have any ever been proposed for consideration by

Midwest. Member firm inspections have shown no customer account activity involving discretionary authority, either to partners or salesmen; thus, no statement of practices in the handling of such accounts has been necessary. An exchange rule does, however, stipulate the scope of supervision of such activity within a member firm.

Article XIX. Margins.

Rule 1. Restricts practice of meeting margin requirements or full cash payment of purchases through liquidation of the same or other commitments.

Rule 2. Prescribes records to be kept.

Article XX. Capital, questionnaire and report requirements.

Rule 1. Notification requirement to the exchange from any member proposing to do business with the public or to become a "clearing member."

Rule 2. Prescribes the minimum liquid net worth requirement of member firms as the greater of $25,000 or 6⅔ percent of firm's aggregate indebtedness.

Rule 3. Individuals on admission to membership must have a minimum personal liquid net worth of $10,000, exclusive of the cost of the membership.

Rule 4. Requires the filing of two audited financial questionnaires annually, of which one must be certified by an independent public accountant; independent audit must be on a surprise basis. Additional questionnaires may be requested at any time by the exchange.

Rule 5. Requires annual information report by members not doing business with the public.

Rule 6. Defines "net capital" for computation under the rule.

Rule 7. Defines "doing business with the public."

Rule 8. Defines "aggregate indebtedness."

Rule 9. Requires each member firm and member corporation to carry "brokers' blanket bonds" in amounts prescribed by exchange.

Rule 10. Requires member firms to carry fidelity bonds covering general partners in amounts prescribed by exchange.

SEC Study Group comment and recommendation.—Minimum net capital requirements should be set up and appropriately scaled to reflect the type and size of business conducted. Firms engaged in underwriting activities should have minimum net capital of $50,000.

MSE comment.—With a record of no losses to the public due to financial failure of a Midwest or Chicago Stock Exchange member firm, and no apparent evidence of inadequacy of our present net capital rule, the exchange sees no need, from its standpoint, for any change in this rule. It should also be pointed out that unlike the SEC, the NASD and other exchanges, the Midwest allows an aggregate indebtedness of only 15 times capital as compared with 20 times by others. The study also makes this observation: "The Midwest Stock Exchange devotes considerable effort to enforcement of its capital rule."

Article XXI, discipline and trial proceedings

Rule 1 and 2. Procedures to be followed involving disciplinary matters requiring written report of investigation, the filing of written charges and hearings before the president or judiciary committee; or waiver of written charges by the member with a hearing before the president. All penalties subject to appeal by member.

Rule 3. Procedure upon admission of charges.

Rule 4. Procedure on request for hearing on penalty requires appointment of judiciary committee.

Rule 5. Provides for trial before president or judiciary committee when charges are not admitted to.

Rule 6. Trial procedure calls for written answers to charges; accused has right to examine and cross-examine witnesses.

Rule 7. Accused has 5 days in which to appeal.

Rule 8. Decision of judiciary committee reviewable by board of governors. (Related exchange rules: see notations art. XVI, authority of exchange re members, partners, salesmen, etc.; art. XVII, business conduct.)

SEC Study Group recommendations.—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 executive committee or board of governors, should be publicly reported; staff-imposed sanctions should be periodically reported to the Commission.

SEC Study Group comment.—The exchange staff plays a crucial role in the administration of the MSE and in regulating member conduct, again highlighting the importance of a paid staff, with sufficient authority and responsibility to accomplish effective self-regulation. The important role played by the MSE president in the exchange's disciplinary machinery and in its total administration contributes to the efficient performance of the exchange's role as a self-regulating agency.

MSE comment.—Present procedures provide for announcement to the membership of penalties involving suspension or expulsion. Whether an action is taken by the board of governors or a committee should not always be the determining factor in making the penalty public information. Midwest proposes that any penalty resulting from an incident in which the public or dealings with the public is involved, that such penalty be publicized whether the action is taken by the board of governors, a committee or the president. Midwest also agrees to publicize all penalties among the membership which would seem to be of informative and educational interest, although in such cases, identity of the member would not be disclosed.

Under chapter XII of the Special Study, the following comment and recommendation is also made:

SEC Study Group comment.—The impact of the public advisers on Midwest Stock Exchange affairs appears to be minimal, thus giving the appearance of public representation in exchange affairs more than the actual fact. The public advisers * * * are more involved in matters of listing than in the regulatory process.

SEC Study Group recommendation.—The exchange should undertake a reassessment of the institution of public advisers to determine whether it can become a more effective instrument for representation of the public in exchange affairs.

MSE comment.—The services of public advisers have only been used in broad matters of public interest; hence, they have not participated in the internal and regulatory aspects of exchange operations. It does not appear feasible or practical to use the services of public advisers who are uninformed in the workings of the securities business to participate in the adjudication of charges involving the violation of exchange rules.

Midwest agree to reevaluate present procedures in the light of the Study Group recommendation and to make such changes as it deems advisable in the public interest.

Article XXII. Listed securities

Rule 1. Authority of board of governors to admit securities to the list.

Rule 2. Securities may be suspended by the board or by the president.

Rule 3. The board may remove securities from the list on application of the issuer or on motion of the president. When requested by the issuer, a vote of stockholders is required, unless waived by reason of the existence of special circumstances.

Rule 4. Application may be made by the exchange to the SEC for unlisted trading privileges.

Rule 5. Securities may be allocated to a "cabinet system" for trading, where there is insufficient volume to retain in the specialist system. Such issues may be traded away from the exchange without specific permission.

Rule 6. Provides for procedures in trading away from the exchange in listed issues.

Rule 7. Provides for dealings on the exchange of "when issued" and "when distributed" contracts.

SEC Study Group comments.—For a security to be well suited for trading in a continuous auction market, spontaneous meeting of buyers and sellers must occur on a reasonably continuous basis; the market must have adequate "depth."

SEC Study Group recommendation.—Listing and delisting standards and practices of the several exchanges require reexamination from time to time to assure that the entire list of securities being traded is in keeping with the kind of market that the particular exchange purports to provide and is capable of providing.

MSE comment.—The Midwest Exchange has pioneered in exhaustive market studies to determine proper qualifications of eligibility for the exchange market. One of the results was the revolutionary step of designationg a "No" unit of trade to issues not meeting the normal exchange market standards. This permits direct transactions between members in any number of shares, from one up;

it also permits dealings off-board, giving such issues the maximum benefit of market interest—in the unlisted as well as the listed. Removal of such issues should, in the exchange's opinion, "be a matter for the issuer to resolve, inasmuch as the exchange has provided broad flexibility of operations in the best interests of investors and the issuers."

Other issues, somewhat limited in "market depth," but remaining in the specialist system, are afforded through the specialist the facilities for buying and selling to meet the needs of these issues, some of which are assigned a smaller "unit of trade." We do not believe it would be in their best interests to delist such stocks.

Initial listing standards for issues to be listed only on Midwest provide for total assets of $2 million; 200,000 shares of stock outstanding, and 1,500 stockholders. The exchange has no prescribed minimum for delisting due to marketability factors for the reasons stated above.

SEC Study Group comments on the third market.—"The third market requires evaluation of the advantages of competition with reference to possible impairment of the depth of the primary market."

MSE comments.—As Midwest is a secondary market in such issues, it is not directly affected, although indirectly. For that reason, we have stated that certain restrictions and regulations applicable to the listed markets be to the same extent applied to the trading of such listed issues in the third market. This would also include the specific recommendations contained in chapter VIII–D of the Special Study Report.

Article XXIII. Special offerings

Rules 1 through 8. Details rules of procedure in effecting distributions of blocks of stock in which all member firms may participate, through the facilities of the exchange, under the title of "Special Offerings."

Article XXIV. Specialists

Rule 1. Application procedure for appointment of specialists.

Rule 2. Precedence of orders in the book.

Rule 3. Specialist has no preference at the post as specialist. A specialist, with orders in the book, shall not "stop" himself.

Rule 4. Specialist's book confidential.

Rule 5. Written report required of specialist on every transaction.

Rule 6. Consultation required on opening when unusual conditions exist.

Rule 7. Activities, financial condition and specialist's book subject to examination by exchange officials.

Rule 8. Right to terminate registration of a specialist.

Rule 9. Limitation in effecting transactions for own account.

Rule 10. Joint account participants limited to a partner, a cospecialist, relief specialist or another exchange member.

Rule 11. Requirement for record of all orders placed with specialist, of executions, modifications to be kept 1 year. Responsible for proper entry and time-stamping of all orders received.

Rule 12. Prohibits any pool dealing or trading, acquiring or granting any options in any issue in which the member is specialist.

Rules 13. Registration fees.

Rule 14. Specialist's book to be attended constantly, from before opening to the close.

Rule 15. Claims for reports must be made by 10:30 a.m. of following day.

Rule 16. Exchange may conduct surprise audit of specialist's position.

Rule 17. Exchange shall conduct surprise audit of specialist's position twice annually in issues listed only on MSE.

Rule 18. Unusual activity in a local listing may be subject to scrutiny and the filing of a questionnaire by participating members.

Rule 19. Specialist may bid at a higher price than last sale in a local issue, only with approval of two members of committee on floor procedure.

SEC Study Group comments.—Further studies are needed of regional exchange specialist systems and no changes should be made pending such studies. Regional exchange specialists should be exempted for the present from certain rules under 11(b) of the Exchange Act.

As the several Special Study conclusions and recommendations are specifically directed to the two primary markets, no further reference is made to these items.

Article XXV. Odd lots and odd lot dealers, dual system

Rule 1. Floor procedure committee may designate the trading unit of all issues; the odd lot differential and the issue to be dealt in under the dual trading system.

Rule 2. Defines an odd lot.

Rule 3. Defines an odd lot dealer; authorizes appointment of agents subject to exchange approval; dealer responsible for errors and omissions of agents.

Rule 4. Defines an odd lot agent.

Rule 5. Only members duly registered as odd lot dealers can act as such. Written application required for action by floor procedure committee.

Rule 6. Odd lot dealer required to buy or sell all odd lots bid for or offered on the terms and basis prescribed in this rule.

Rule 7. With approval of a committee member, odd lots may be filled on the basis of the bid or offer.

Rule 8. Restrictions on short sales of odd lots by other members.

Rule 9. Odd lot orders from customers may be combined into a full lot, only with customers' approval. Odd lot orders for various accounts in which there is a common financial interest shall be, if possible, combined into a full lot.

Rule 10. Odd lot orders in dually listed issues may be filled on basis of round lot price on Midwest or the primary market. When order is to be filled on basis of the latter, order is effective 3 minutes following receipt of order by odd lot dealer.

Rule 11. All orders must be in writing and time-stamped on receipt on floor and again on receipt by the dealer.

Rule 12. Odd lot operations subject to scrutiny and supervision.

Rule 13. Joint account activity by an odd lot dealer in any of issues so registered shall be limited to other members or partners of member firms.

Rule 14. Odd lot dealer prohibited from acquiring or granting any option of any type in an issue in which he is so registered.

Rule 15. Floor committee may suspend dealings in odd lots by an odd lot dealer or agent, and may withdraw the registration of a dealer or agent.

Rule 16. Procedure of filling a limited odd lot order under certain conditions.

Rule 17. Basis for filling odd lots in dual issues received immediately before the opening or close of the market.

SEC Study Group comment.—Certain of the regional stock exchanges which theoretically might be a competitive factor with respect to dually traded stocks, have acceded to pressure for uniformity exercised by the New York odd lot firms and the dual members (referring to odd lot price differentials— one-eighth and one-quarter).

Inasmuch as the Special Study's consideration of the odd lot business was essentially limited to the New York Stock Exchange, the Commission should, in conjunction with the American Stock Exchange and the regional exchanges, undertake studies of the methods and costs of handling odd lots on those exchanges.

MSE comment.—Midwest agrees to cooperate in any proposal for a study of the methods and costs of handling odd lots on this exchange.

Article XXVI. Branch offices of the exchange

Rules 1 through 6. Refers to the operation of two branch offices of the exchange—in Cleveland and St. Louis—used as central communications centers for the member firms in these cities.

Article XXVII. Advertising

Rule 1. Requirement for the filing with the exchange of member firm advertising.

Rule 2. Requirement for approval by a partner of market letters issued by member firms and for retention of copy for 3 years.

Rule 3. Requires approval of the exchange for use by members of radio or television broadcasts.

SEC Study Group recommendation.—The self-regulatory agencies should give more positive and effective attention to the issuance of investment advice by member firms through market letters, advertisements or otherwise. Standards should be established through statements of policy.

More effective market letter surveillance should be taken by the NASD and other exchanges, or a coordinated program of self-regulatory agencies should be evolved.

MSE comment.—A very limited number of Midwest firms (not members of New York Stock Exchange) issue market letters or advertise in the public press. However, the exchange has already taken initial steps to supervise this activity and to establish acceptable standards both for advertising and market letters.

Article XXVIII. Dues, fines, net commissions and other charges, penalties for nonpayment

Rule 1. Member dues fixed by board of governors. Last quarter dues may be increased or decreased.

Rule 2. Sets fiscal year of the exchange.

Rule 3. Rate of net commission fee determined by board of governors.

Rule 4. Requires monthly report of commissions earned on exchange transactions and payment of net commission fee.

Rule 5. Requirement for filing final report on transfer of membership or dissolution of firms.

Rule 6. Report from individual member who retires from a member firm.

Rule 7. Provision for waiving of report requirement.

Rule 8. Authority of board of governors to impose other fees .

Rule 9. Dues prorated on transfer of membership to a new member.

Rule 10. Estates holding memberships, suspended or expelled members, are subject to dues payment.

Rule 11. Individual member who has registered a firm is personally responsible for charges applicable to the firm. Member subject to suspension, if dues or other charges are not paid within 30 days.

Rule 12. Any member suspended 4 times under this rule ceases to be a member.

Rule 13. Suspension of an individual member automatically terminates membership status of his firm.

Rule 14. Dues may be waived for member in active military service or devoting full time to any public service incident to national defense.

Article XXIX. Commissions

Rule 1. Requires members to charge not less than specified minimum rates of commission, free of any rebate, return or discount. Members may enter into reciprocal arrangements with each other, with such arrangements reported to the exchange.

Rule 2. The schedule of minimum commission rate on stocks.

Rule 3. Minimum commission rates on bonds.

Rules 4 through 15. Details relating to various situations relating to commissions.

Rule 16. Arrangements with customers for special or unusual interest rates prohibited.

Rule 17. Exchange registration fee under the 1934 act charged the customer.

Rule 18. Floor member not permitted to pay rental of floor telephone booth or cost of private telephone or wire used by member firm.

Rule 19. Members may charge commission rates of another exchange.

Rules 20 and 21. Arrangements can be made between floor members with approval of floor committee to service a fellow-member's business without loss of income to such absent member.

SEC Study Group comment.—Concerned with the commission rate structure and the impact of this structure on the markets; also the procedures and standards involved in setting and review of rate levels. The New York Stock Exchange rate structure in use by American Stock Exchange and the regional exchanges. Various ad hoc practices designed to temper the rigidity of the schedule have developed. These include reciprocal arrangements between members and the payment of give-up commissions between members. These practices have produced a variety of questionable consequences.

SEC Study Group recommendation.—The detailed and technical recommendations as contained in chapter VIII are not repeated here inasmuch as they are directed to the New York Stock Exchange, all of which involve joint Commission and exchange study.

MSE comment.—While the comments and recommendations are directed primarily to the New York Stock Exchange, any changes instituted would of necessity be of concern to Midwest.

Due to the nature and extent of the subject, it would be impossible at this time to foresee the effects of basic changes in the commission rate structure, as well as the rates themselves. In, the transmittal letter of the Chairman of the Commission, it is well observed that "any proposals regarding the structure of

the New York Stock Exchange commission rate schedule must be premised upon a thorough understanding of the impact any change in that structure would have on other sectors of the securities market, such as the regional exchanges."

With reference to reciprocal arrangements, Midwest recognized this condition or "way of doing business" several years ago by requiring member firms to report to the Exchange any existing reciprocal understandings or agreements with other member firms. By so doing "reciprocal business" was placed in proper perspective and under surveillance of the exchange.

Midwest certainly agrees to a joint study of the rates of commission and the rate structure in the light of the Special Study's comments and observations.

The specific recommendation that the odd lot differentials of one-eighth or one-fourth point be shown separately on confirmations to customers presents certain technical problems; aside from this, the public is often informed through printed material and by other means of this charge of the odd lot dealer, which has been in effect for many decades. Midwest would have no objections to a required notice or informative statement on this subject to odd lot customers as part of an educational program.

Article XXX, Exchange distribution plan

Rules 1 through 5. Recites the procedures to be followed by a member firm desiring to effect a distribution of a block of stock through the facilities of the exchange.

Article XXXI. Proxies

Rule 1. Prohibits giving of proxies by a member, except as provided for in the rules.

Rule 2. Requires member firms to transmit proxy material to beneficial owners, upon being supplied such material by the person soliciting proxies and upon being assured of reimbursement of expenses incurred.

Rule 3. States conditions under which a member can be given a proxy for stock registered in its name.

Rule 4. Each proxy shall state the actual number of shares represented by such proxy.

Rule 5. Requires a member firm to transfer certificates into its own name for purposes of proxy solicitation, when requested by the exchange.

Rule 6. Proxy rules applicable to individual members as well as member firms and their nominees or employees.

Rule 7. Requires member firms to transmit to beneficial owners copies of items being sent to stockholders upon assurance that expenses incurred will be reimbursed by the company.

Rule 8. These proxy rules are applicable to issues listed exclusively on Midwest.

Mr. STAGGERS. Mr. Van Deerlin, do you have any questions?

Mr. VAN DEERLIN. Mr. Day, in Mr. Funston's testimony yesterday regarding the findings of the Sepecial Study Group, he voiced concern over two recommendations that were made by the Study Group: one, concerning floor trading; and the other off-board trade on listed securities.

Do you share Mr. Funston's concern in these areas, or has the matter not been given sufficient study yet by the Midwest Exchange?

Mr. DAY. I agree with Mr. Funston on all his points regarding the third market. He also makes a point of dual trading, which, of course, we do on our exchange. I do not share his concern and I have outlined in reasonable depth our reasons in my letter to Chairman Harris. I would be happy to read that.

Mr. STAGGERS. Mr. Glenn?

Mr. GLENN. I have no questions, Mr. Chairman.

Mr. STAGGERS. Mr. Hemphill?

Mr. HEMPHILL. No, thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Keith?

Mr. KEITH. I have no questions.

Mr. STAGGERS. Mr. Curtin?

Mr. CURTIN. I have no questions, Mr. Chairman.

Mr. STAGGERS. Mr. Day, on page 8 of your letter of November 14, you complete your indictment of the Commission's encouragement of trading in the third market.

Mr. DAY. Yes, sir.

Mr. STAGGERS. By saying that such trade in listed securities should be restricted or prohibited, do you have language prepared or would you care to submit language that would carry out this prohibition?

Mr. DAY. I would sure like to try it. I don't have it. I know it is a difficult area. I am sure of one thing, and that is that there should not be a double standard as far as the public is concerned or business itself is concerned. I see no point in permitting someone to deal in securities under a different set of regulations.

We think anybody is entitled to buy and sell American securities at any time, as long as they do it on the same basis as far as rules are concerned.

This is particularly important, Mr. Chairman, not just for the rules themselves, but because when you don't have to keep records, don't have to conform to rules and have people see that you do, your economic costs are much lower, so there is no way you can compete.

Mr. STAGGERS. We will give you an opportunity, if you care to, because I believe that is the democratic process of those who are interested in the legislation, to give their views.

Mr. DAY. We will make a try.

(The following material was subsequently received for the record:)

MIDWEST STOCK EXCHANGE,
Chicago, January 10, 1964.

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Longworth House Office Building,
Washington, D.C.

GENTLEMEN: At the Midwest Stock Exchange's appearance before the committee, we introduced into the record specific comments on the practice of trading listed securities in the over-the-counter market. The exchange's position was that it had no objection to anyone's inherent right to deal in listed securities and it believes that competition is as important in the marketplace as it is in any other form of business. However, we stated that where rules and regulations for public protection have been established by authority of Congress, they should be adhered to in all market places dealing in the securities so regulated.

As a result of our comments, we were asked to submit a proposal to supplement our filed statement to the effect that over-the-counter trading in listed securities, unless properly regulated, should be restricted or prohibited. We are pleased to do so as follows:

The over-the-counter market in listed securities was developed originally mainly as a facility for trading large blocks of securities. Typical were issues of public utilities. In recent years, there has been a tremendous increase in securities buying by both institutions and the public. In the same period, trading in listed securities over the counter (referred to in the Securities and Exchange Commission Study Report as the "third market") appears to have grown percentagewise substantially more than the listed marketplace. From the third market's original dealing in large blocks, we now find it dealing in a broad cross-section of listed securities not only in blocks, but 100-share lots and even odd lots.

To permit the so-called third market to deal in listed securities without requiring basic safeguards is, in our opinion, not in the public interest.

It is axiomatic that unregulated buying and selling will soon drive out regulated sealings from a cost standpoint alone.

We believe the following comparative outline points out clearly the disparity in public protection that exists between an exchange market and the third market:

EXCHANGE MARKET	THIRD MARKET
1. Exchanges must be registered with the SEC and file periodic reports and maintain certain basic facilities.	No registration required except as individual dealer firms under section 15A.
2. The exchanges have self-regulatory responsibility and authority with reference to trading markets in listed securities acceptable to the Commission.	No such requirements.
3. Individuals that make markets must be registered with the exchange to become a market maker or specialist.	No such requirements. Anyone in the third market can trade any issue at any time. It is possible to start trading an issue on one morning and drop it the next day.
4. To terminate registration as a market maker in an issue, notifiaction must be given and approval received from the exchange.	No such requirements.
5. In all listed issues traded by a registered specialist on an exchange he is required to maintain a fair and orderly market and is supervised by the exchange to insure his activity is proper.	There are no rules or regulations regarding a fair and orderly market and no supervision related to price, activities, etc.
6. The specialist on an exchange is required to quote a firm bid and offer and maintain a continuous market. The quote is expected to be in reasonable relation to previous sales and good for a designated amount.	There is no requirement to quote a firm or continuous market. Either side may be quoted.
7. The exchanges must make full disclosure of prices and amounts of each sale which immediately becomes available to the investing public.	There are no means available to advise the investing public as to sales or prices.
8. At the close of daily trading hours, all transactions, sizes, prices, high, low, and close are publicized in the newspapers.	There is no disclosure at any time as to prices, amounts, etc.
9. Exchanges have an established mechanism for execution of odd lots on a fixed differential basis.	No announced procedures for the execution of odd lots.
10. On the exchanges customers' bids and offers receive precedence over specialists' bids and offers at the same price.	No known established procedures.
11. On exchanges short sales can be made only in accordance with SEC-approved restrictions.	Short sales may be made at any time, under any conditions.
12. Specialist activity on the exchanges is restricted to what is reasonably required to maintain a fair and orderly market.	No restrictions of any kind.
13. Procedures exist for spotting unusual market activity or undue market influence. Records must be maintained for market reconstruction to pinpoint responsibility.	No known way of spotting unusual activity or method of reconstructing sales and price movements.
14. Exchanges provide facilities for the public to enter limited orders and procedures are established to give them precedence and proper execution when entitled.	No facility.

EXCHANGE MARKET	THIRD MARKET
15. Exchanges are required to provide many additional services such as maintenance of public records on listed companies.	No parallel requirements.

The difference indicated in the above comparison point up a great void in public protection and has permitted the creation of a double standard.

It is not proposed that all minute rules, regulations, and practices instituted by listed markets be imposed arbitrarily on the third market for the mere sake of uniformity. The need, however, is obvious for basic safeguards that should be adopted immediately in the public interest. They are:

(1) Registration with the Commission of all broker-dealers who maintain a market in listed securities off-board. Registration should be required for each issue and notice given when the market is abandoned.

(2) All market makers in the third market should be required to maintain a complete set of books and records on their trading and in such fashion to permit reconstruction of any market situation for proper policing and evaluation.

(3) Short selling should be restricted in a comparable fashion as required in the listed marketplace, in the best interests of investors, and to plug a loophope in the intent of the short-selling rule.

(4) An approved uniform method for the handling of odd-lot transactions should be established.

(5) Some capital requirements should be established consistent with the important position of market makers.

(6) Examination (audit) procedures designed to fit the needs of the third market should be undertaken by the SEC or NASD.

(7) The SEC should grant permission to market makers in the third market only after it has been established that such is necessary or appropriate in the public interest or for the protection of investors. One prime consideration would be whether there is a sufficiently widespread public distribution and trading activity in such issue to render the extension of trading proper or necessary.

(8) All regulations now operative or impending for exchanges that are specifically designated for public protection should be adopted by the third market.

(9) Eventually methods should be devised through the use of computers so that volume and prices in the third market would be reported publicly.

Authority

It would appear that the Securities and Exchange Commission has ample authority to immediately provide such protections for investors under the 1934 act. At least two sections of the act could be applied.

Registration of national and affiliated securities associations. Section 15A(b)(7).—"The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges and, in general to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market. * * *"

Accounts and records, reports, examinations of exchanges, members and others. Section 17(a).—"Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep and preserve for such periods, such accounts, correspondence, memorandums, papers, books, and other records, and make such reports as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. * * *"

Very truly yours,

JAMES E. DAY, *President.*

Mr. STAGGERS. I am sure the whole committee listened with interest to your testimony here supporting the extension of certain provisions of the Exchange Act which are now applicable to issues of listed securities, to include issues of securities traded over the counter.

I have also noted the benefits you have claimed in your letter of November 14 that arise from dual trading, that is, trading on exchanges listed on a primary exchange.

Also, I listened with interest yesterday to the statement of Mr. Funston in which he points out the financial condition of a number of exchange firms. Accordingly, Mr. Day, I am wondering whether or not there is any truth to the allegationI have heard made that the whole program of requiring companies whose securities are now traded over the counter to register and be subject to almost the same requirements as though their securities were listed is simply a device to remove a large part of the differences now existing so that more companies will list with your exchanges across the Nation.

Mr. DAY. I am sure that this has been one of the arguments from the start of these bills. This business of equalizing and giving the public the same kind of information whether listed or unlisted starts back at least in my memory some 15 to 18 years ago. This has always been an argument, that this makes it automatic that they will list.

Of course, this is not true. A choice is theirs. I will say that I think that this legislation—in fact, it is already having its effect with us—we have had more new listings recently. But whether you could credit this directly to this bill or proposed bill or whether you can credit it to good markets and a desire to be listed would be hard to pull apart.

I would say that if the cost of giving the public proper information to evaluate securities, the full disclosure principle which I don't think anyone in America disagrees with, if some of these companies might list more rapidly than otherwise, then I would say it is a fine price.

Mr. STAGGERS. I would be inclined to agree with you. For the sake of carrying this further, if this bill is passed, it necessarily would mean more listings on the stock exchanges. It would mean more business; let us put it that way.

Mr. DAY. This may or may not be. I think more business on stock exchanges is the same as any other business. It will depend on economic conditions. I am not trying to hedge on this, Mr. Chairman. I have already said that I think this removal of the double standard would mean more listings. I don't mean it necessarily would be more business. That is due to economic conditions.

Mr. STAGGERS. It is a highly competitive business.

Mr. DAY. We find it exceedingly competitive.

Mr. STAGGERS. You say allegations are made against the bill. I just want to get your point of view. Evidently if it does pass, in a competitive business like this, I am sure it would mean more listings.

I want to thank you for taking the time to give your views. If you will supply for the record the completion of the request of that letter of November 14 and also your recommendations on the bill, we would appreciate it very much.

Mr. DAY. We will, Mr. Chairman. Thank you.

Mr. STAGGERS. Thank you very kindly for coming and giving us the benefit of your views.

Mr. Etherington, will you come forward, please?

Would you state your name and your position, and also the names of the gentlemen that are with you, and their positions, please?

STATEMENT OF EDWIN D. ETHERINGTON, PRESIDENT, AMERICAN STOCK EXCHANGE; ACCOMPANIED BY MARTIN J. KEENA AND KARL CONNELL, OF THE STAFF, AMERICAN STOCK EXCHANGE; AND THOMAS A. McGOVERN OF FORSYTHE, McGOVERN & FETZER, COUNSEL TO THE AMERICAN STOCK EXCHANGE

Mr. ETHERINGTON. My name is Edwin D. Etherington. On my right is Karl Connell, who is the head of our special projects and planning unit at the American Exchange. On his right is Martin J. Keena, vice president of the exchange. On my left is Mr. Thomas McGovern of Forsythe, McGovern & Fetzer, who are counsel to the exchange.

Mr. STAGGERS. You may proceed with your statement.

Mr. ETHERINGTON. For the record I should say I am president of the American Exchange and I live in Montclair, N.J., and I work in New York City.

Mr. Chairman, the American Stock Exchange is in a unique position among the securities industry organizations appearing before this subcommittee.

Twenty-three months ago—on January 3, 1962—a report by the SEC staff concerning the American Exchange was issued and designated as part of the broader special study of securities markets. Since then, the exchange has completed a major reorganization program. Particular emphasis has been placed on effective procedures for enforcement and self-regulation.

The exchange views this program as the core of its response to the Special Study. Accordingly, and in reply to the October 16, 1963, letter from Chairman Oren Harris, we have prepared a comprehensive statement in three parts:

(1) Reviewing the reorganization and related programs of the exchange since January of 1962;

(2) Detailing exchange enforcement and disciplinary procedures in view of the interest specified by the 87th Congress in Joint Resolution 438; and

(3) Presenting the commentary requested by Chairman Harris.

With your permission, we would like to present this material along with a copy of Mr. Harris' letter for the record.

Mr. STAGGERS. It will be included in the record.

(The documents referred to follow:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C. October 16, 1963.

MR. EDWIN ETHERINGTON,
President, American Stock Exchange,
80 Trinity Place,
New York, N.Y.

DEAR MR. ETHERINGTON: As you know, the committee has before it H.R. 6789, which I introduced at the request of the Securities and Exchange Commission, and S. 1642, the companion bill, which has already passed the Senate, which embody legislative recommendations of the Commission growing out of the

2-year study it made pursuant to House Joint Resolution 438, 87th Congress, into the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations.

As of this date, we have not yet set a date at which we will have hearings upon this proposed legislation, but it is my intention to have hearings thereupon when the schedule of the committee's activities so permits. I am sure that you appreciate that inasmuch as the Commission's study was initiated and sponsored by this committee, the committee feels it incumbent upon it to consider this proposed legislation. At the time the legislation is considered, however, it is the committee's intention to review the recommendations of the Commission as to legislation and as to what should be done under rulemaking powers, and also as to the Commission's Special Study findings on the adequacy of the rules of the exchanges and of the securities associations for the protection of investors.

In this connection I am sure that you already have given attention to the Commission's expressions and to the findings of the Commission's Study Group with respect to the adequacy of the various rules which you have enunciated as well as to some which might be deemed appropriate to be promulgated.

I am writing this letter to you accordingly in anticipation of the hearings which we shall have on the legislation and the study, and of your appearance before the committee at that time expressing your opinion thereupon so as to make sure that you develop in your appearance, if not before that time, your analysis of all of your rules and the comments of the Commission and of the Study Group on each of your rules as to the adequacy of each rule, for the protection of investors, and the suggestions of what additional rules should be considered by you.

Sincerely yours,

OREN HARRIS, *Chairman.*

AMERICAN STOCK EXCHANGE,
New York, N.Y., November 16, 1963.

HON. OREN HARRIS,
Chairman, Interstate and Foreign Commerce Committee,
House of Representatives, Washington, D.C.

DEAR MR. HARRIS: In your letter to me of October 16, 1963, you referred to H.R. 6789 and Joint Resolution 438 (87th Congress) and stated:

"I am writing this letter to you accordingly in anticipation of the hearings which we shall have on the legislation and the study, and of your appearance before the committee at that time expressing your opinion thereupon so as to make sure that you develop in your appearance, if not before

that time, your analysis of all of your rules and the comments of the Commission and of the study group on each of your rules as to the adequacy of each rule, for the protection of investors, and the suggestions of what additional rules should be considered by you."

Following the enactment of Public Law 87–196, the Securities and Exchange Commission directed that a staff investigation concerning the American Stock Exchange, then being conducted, be continued as part of the broader study ordered by the Congress. On January 3, 1962, the staff report was transmitted to the Commission and made public. It has also been reprinted with the "Special Study of Securities Markets" submitted to the Congress this summer.

The exchange views its reorganization, and the additional steps it has taken since early 1962 to make its procedures and services more effective, as the major part of its response to the Special Study. Accordingly, the attached statement includes:

(1) a review of the reorganization and related programs of the American Stock Exchange since early 1962;

(2) a description of the exchange's market surveillance, investigations and examinations programs, and procedures for handling disciplinary matters;

(3) a commentary on the exchange's constitution and rules with a summary of the Special Study proposals and Commission comments relating to the exchange as requested in your letter.

In submitting this statement, the exchange has noted that Joint Resolution 438 (87th Congress) authorized and directed the Commission to study and investigate "the adequacy, for the protection of investors, of the rules of the national securities exchanges * * * including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade * * *."

The adequacy of the constitution and rules of the exchange for the protection of investors must be judged in significant measure by the adequacy of procedures to take effective disciplinary action in appropriate cases. Accordingly, the statement describes these disciplinary procedures, as well as the scope and method of procedures for market surveillance and related matters, in some detail.

The exchange is submitting, in addition, a separate statement of its reasons for supporting H.R. 6789.

We hope this material is fully responsive to your letter and appreciate the opportunity you have afforded us to express our views during the hearings.

Respectfully submitted.

EDWIN D. ETHERINGTON.

STATEMENT OF THE AMERICAN STOCK EXCHANGE

INTRODUCTION

The American Stock Exchange has completed a comprehensive reorganization program during the past 23 months. New programs and procedures based on a completely revised policy-making and management structure have been developed. Particular emphasis has been placed on effective procedures for enforcement and self-regulation.

The S.E.C. issued a Staff Report on January 3, 1962, focused directly on the American Exchange. This document was designated as part of the Special Study of Securities Markets completed this year. The Exchange's program since early 1962 is the core of its response to that part of the Special Study and of its presentation to this Committee.

The Exchange's first reaction to the 1962 S.E.C. Staff Report was developed by a special committee of nine members (popularly known as the "Levy Committee") appointed by the Exchange on October 12, 1961,

> "to make a comprehensive review of the organization, rules, policies and procedures of the Exchange and to recommend such revisions, additions or eliminations which it believes would increase the effectiveness of the operations of the Exchange and enhance the service to the public."

Four months later, the Levy Committee completed its work, noting that it had reviewed and considered the S.E.C. Staff Report as well as testimony taken by the S.E.C. Staff.

The Levy Committee reports were endorsed in principle by the Exchange Board of Governors and are submitted with this statement as Exhibit "A".

The Exchange has now implemented the major recommendations of the Levy Committee with some revisions based on further study. The steps taken were summarized this summer in Chapter XII-C of the Special Study which concluded:

> "The Exchange has thus undergone a major constitutional and organizational reform. 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."

The reorganization and related programs of the Exchange are reviewed in Part I of this statement. Enforcement and disciplinary procedures are detailed in Part II in view of the interest expressed by the Congress in H. J. Res. 438 (87th Cong.). Part III summarizes the Constitution and Rules of the Exchange, refers to the related recommendations and comments of the Special Study and the Commission, and presents the Exchange's comments. Provisions directly applicable to the protection of investors are designated by an asterisk.

PART I

REORGANIZATION OF EXCHANGE SINCE EARLY 1962

In the last of its three reports, dated February 15, 1962, the Levy Committee made these comments:

> "Under the Securities Exchange Act of 1934, national securities exchanges, including the American Stock Exchange, are granted the primary responsibility for the regulation

of conduct of their own members. The Exchange must assume that responsibility in a way entirely consistent with the public interest. Although the Exchange as an institution represents a broad community of firms and companies, the starting point is the individual, allied or associate, member. Thus the Committee has been gratified to find a recognition and acceptance of public trust by those who have testified.

"Recent events have demonstrated the need for drastic internal changes. The solution of difficulties that have appeared, and the prevention of similar problems in the future, must commence with a revision of the organization and a strengthening of the management of the Exchange as previously recommended. When this is accomplished, a basis will exist for proper enforcement and self-policing."

The program of the Exchange has been in direct response to these observations. It has centered around four structural changes designed to enable the Exchange to furnish greater and more effective service to the investing public.

Structure of Organization and Management

In June of 1962, the membership approved by a vote of 439 to 22, a general amendment of the Exchange's Constitution. A summary of the amendment is set forth in a memorandum of June 9, 1962. (Exhibit "B".) In broad outline, the amended Constitution:

(1) Establishes the Board of Governors as the sole policy-making body of the Exchange with representatives from major segments of the securities industry throughout the country, as well as individuals not in the securities business;

(2) eliminates standing committees and centers responsibility for administration and operations in the President and a professional staff who are not active in the securities business as such; and

(3) provides an operating framework firm enough to insure the above division between policy and administrative responsibilities, but flexible enough to permit prompt and decisive action by the Exchange as required in the public interest.

Prior to the amendment of the Constitution, a new Chairman had been elected. He served, in addition, as President *pro tem* and as chairman of a committee to select a new President.

On September 4, 1962, the Exchange's reconstituted Board of Governors, a new President and several new officers took office. The following actions were taken two days later:

(1) Extensive revisions of the rules were approved to eliminate references to the former standing committees and to make other procedural changes consistent with the amended Constitution;

(2) an Advisory Committee of Governors was appointed, with a Subcommittee on Admissions to screen applicants for membership and allied membership, and procedures were established for rotating the membership of these committees;

(3) Floor Officials were appointed and a new rule was adopted designating their duties; and

(4) as authorized by the amended Constitution, the Board delegated the necessary administrative authority to the President, and approved his redelegation to other officials. (Exhibit "C".)

Over the period of its reorganization, the Exchange's administrative staff has been grouped into six major divisions and augmented by the addition of 104 new employees. Of these, 28 are executive, professional or supervisory personnel and 76 are supporting personnel with the heaviest concentration in areas primarily concerned with regulation and enforcement. There are 276 people assigned to duties directly related to market surveillance and investigations, as distinguished from administrative and service responsibilities.

As part of its internal administration, the Exchange's organizational lines have been clearly established, extensive refinements have been made in the operating budget, and a controller's office has been established. Approximately 12,600 square feet of new space have been allocated for administrative offices.

Although organizational changes and management improvements are under constant review, the Exchange can point to these steps as evidence that the structure of its internal organization is responsive to the demands placed on it, and to the needs suggested in the S.E.C. Staff Report and specified in the recommendations of the Levy Committee.

Structure of Membership

On September 6, 1962, the Board approved the appointment of a Special Committee of Governors to review the structure of the membership with emphasis on the status of associate member organizations—broker-dealers doing business through the Exchange's facilities without having a proprietary interest in its affairs. In a report to the Board on March 28, 1963, that Committee concluded:

(1) The Exchange would and should be materially strengthened through a program to broaden the base of its regular membership; and

(2) the associate membership category should be continued in the best interests of the Exchange and the securities industry as a whole.

Based on these recommendations, the Board unanimously adopted, and the membership subsequently approved by a vote of 290 to 165, the first membership expansion program in 43 years. An additional 101 new memberships were authorized for issuance during 1963 to representatives of qualified associate member organizations. Another 50 new memberships may be issued through 1965. The details of the plan, and the text of the enabling amendment to the Exchange's Constitution, are set forth in an April 1, 1963, memorandum to the membership. (Exhibit "D".)

To date, there have been applications for 91 of the 101 memberships initially available, and the Board has approved the admission of 81 of these associate member organizations to the regular membership. The remaining applications are being processed.

The restructuring of the membership has three principal advantages:

(1) It makes the Exchange's facilities available to as many as 151 additional leading broker-dealer firms, giving them a direct, proprietary interest in the Exchange's operation;

(2) it will broaden the national scope of the Exchange's market, as indicated by the fact the 91 associate member organizations reserving seats under the program to date have 547 offices in 305 cities in 46 states from coast to coast; and

(3) it encourages additional broker-dealers meeting the Exchange's admission standards to become associate members without committing the capital funds necessary for the purchase of a regular membership. Over the years, as the business of these associate members expands, they can be expected to seek regular memberships.

This membership structure provides for present and future growth without lessening the Exchange's standards. For the American Exchange, it is sound, meets the public's needs effectively, and is consistent with goals generally described in the Special Study.

Structure of the Stock List

On April 5, 1962, the Exchange established higher standards for companies seeking to list their securities and adopted new criteria which it expects companies to meet in order to warrant continued dealings. The details of these standards and the Exchange's over-all listing policies are described in Exhibit "E".

The new standards are designed to enhance the Exchange's list by attracting issues suitable for dealings on a national market and by removing those issues which, because of limited share distribution or lack of earnings, are no longer suitable.

Since April of 1962, 104 stock issues of 100 companies have been admitted to dealings. The list today totals approximately 1.75 billion shares, representing 1015 issues of 933 companies.

On September 6, 1962, the Board of Governors approved the appointment of a special committee of Governors to review the status of each company that failed to meet one or more of the Exchange's standards for continued dealings. The Committee has just submitted its final report, pointing out that 63 issues have been removed or suspended from dealings in the course of a year-long, company-by-company study. A summary of the Committee's report is contained in Exhibit "F". The review of issues which may be subject to delisting in the future will be continued.

A company listing on the Exchange under current standards must make available, at the time of listing and periodically thereafter, financial data investors should have in reaching their decisions. Among other things, a company commits itself to:

(1) Furnish independently-audited annual reports and, during the year, periodic earnings statements;

(2) publicize promptly, and notify the Exchange of, any action regarding dividend payments, or non-payments;

(3) solicit proxies in conformance with S.E.C. rules so that stockholders not only have the material they need for investment decisions, but also have the means of registering their votes; and

(4) seek stockholder approval before issuing additional shares for certain types of acquisitions, or before granting stock options to officers, directors or key employees.

Beyond these and other formal listing requirements, described in Exhibits "G", "H", "I", and "J", the Exchange has emphasized that it expects listed companies to follow a policy of timely

disclosure and to make prompt announcement of any news, good or bad, which might affect securities values and in which stockholders have a warrantable interest. The Exchange is also in frequent communication with companies whenever its market surveillance program (described below) indicates there may be information which should be publicized.

The period since April of 1962 has given the Exchange an excellent opportunity to weigh its new listing and delisting standards, to test the effectiveness of its timely disclosure policy and to gauge the impact of these on the Exchange's operations and on the public.

Exchange policies are under constant review and from time to time there may be further adjustments or additional provisions related to the listing of securities or the removal of issues from dealings.

The new standards appear to have helped attract well-established companies to the list without barring those companies for which the Exchange has historically provided a market place. By the same token, delisting criteria have prompted the removal of those companies which by reason of size, share distribution or lack of earnings, are no longer suitable for dealings on a national auction market.

Finally, the policy of urging timely disclosure by companies has helped create markets that are fair, open and responsive to the public's decisions to buy and sell.

Structure of Facilities

The Exchange has taken two major steps to improve existing services to the public, broaden the availability of market data and strengthen the safeguards afforded investors:

(1) In February of 1963, the Exchange entered into new arrangements with The Teleregister Corporation which call for automating the present telephone quotation service through data processing equipment operated by Teleregister in downtown New York City. Early next year, member firms subscribing to the Exchange's quotation service will be able to dial their inquiries through a standard telephone and receive, almost instantaneously via an electronic voice mechanism, the bid, asked, open, high, low, last sale, volume and net change in any stock traded on the Exchange.

As part of this automation program, a combined ticker-quotation input station is now in the final stages of construction at the Exchange. It will relay market data to the computers which, in turn, will feed the telephone-answering machine. This progress represents a first step toward other possible electronic developments the Exchange is studying.

The Exchange will realize a net saving of several million dollars through revision of the original plans for this automation program. These savings were critically important during a period when the Exchange added significantly to operating costs and incurred unusual capital expenditures.

(2) In the summer of this year, the Exchange, in cooperation with the National OTC Clearing Corporation, inaugurated a pilot program to clear and settle transactions in over-the-counter securities having active markets in the New York area. The early stages of this program have been successful. About 1,200 over-the-counter securities are now being cleared through the Exchange's facilities. Through this service, provided by the Exchange's Clearing Corporation for the National OTC Clearing Corporation, the financial community and its customers have the advantages of quicker, more accurate and more economical clearances and settlements.

Related Programs

These four structural changes have positioned the Exchange to meet the public's needs effectively, to help pace the continued growth of the securities industry on a sound basis, and to operate efficiently. The structural changes have been accompanied by new or improved programs and procedures. For example:

(1) ***Communications facilities*** linking the Exchange to the public are being broadened and refined. The network now includes 1905 tickers in 392 cities and Canada. In addition to its quotation system, which now includes 538 direct lines to member firm offices and will soon be automated, the Exchange has worked with independent companies relaying last sale and quote data to broker-dealers serving investors throughout the country and in Canada. Improvements in office-to-floor wire networks are under study.

(2) ***Procedures for allocating stocks to specialists*** have been revised in the interests of the public, listed companies and the Exchange. Among the factors reviewed in each case are the nature of the company's business; the number of shares issued and outstanding or reserved for issuance; the present and previous market activity; and the current share distribution. These data indicate, among other things, the probable demand on the specialist's capital and manpower.

Statistics reflecting the performance of specialists in achieving tight, orderly markets are evaluated on the basis of daily reports submitted by each specialist. The data considered include the specialist's participation in the market, the extent to which he moderates temporary imbalances in supply and demand and the continuity of prices he helps maintain.

Each allocation is made by the full Board after information assembled by the staff is weighed by Governors active on the Floor and the recommendation of those Governors is reviewed by the Advisory Committee of the Board.

(3) ***A new listing program*** has been launched and closer liaison is maintained with the managements of companies whose securities are already admitted to dealings. The advantages of listing, and the obligations of a listed company to the public, are explained and the Exchange draws on the views of companies concerning matters of mutual interest.

(4) ***Quarterly reports*** to the membership and the public are supplemented by four regular meetings with the membership each year to explain programs, answer questions and broaden the knowledge and perspective of Exchange management.

(5) ***Procedures of the Board***, its Advisory Committee and the Sub-Committee on Admissions have been established. The Board meets each week. Policy questions are ordinarily reserved for full discussion at one meeting each month.

(6) ***The public information program*** has been expanded to make the Exchange's story available to all investors. The policy of the Exchange is to disclose information about its market, operations and policy decisions promptly and to interpret the facts as clearly as possible for the public.

(7) ***Close liasion with the S.E.C.*** is maintained to assure a complete interchange of viewpoints and retain the existing atmosphere of constructive cooperation on matters of mutual interest, including the suggestions arising out of the Special Study.

These programs have been accompanied by development of a new system for surveillance, investigations, enforcement and the handling of disciplinary matters described in considerable detail in Part II.

PART II

ENFORCEMENT, INVESTIGATIONS, MARKET SURVEILLANCE, EXAMINATION AND DISCIPLINARY PROCEDURES

The 1962 S.E.C. Staff Report on the American Stock Exchange reached the following conclusion:

> ". . . it is clear that the problem does not primarily consist of an absence or inadequacy of substantive rules of conduct. In certain respects the rules of the Exchange are stronger than those of other exchanges and in recent months there has been a veritable flood of new provisions. Undoubtedly there are many areas where the substantive rules will require substantial improvement, but a mere proliferation of substantive rules will be useless if the people subject to the rules do not take them seriously and there are inadequate mechanisms for surveillance and enforcement."

Against the background of this comment, the work of the Exchange in market surveillance, investigations and enforcement, as well as examinations of member organizations, is particularly important. About 60% of the Exchange's personnel and approximately 32% of its operating expenditures in 1963 were devoted to regulating activities designed to provide the public with markets that are fair, orderly and open. The work in these areas has been of primary concern during the reorganization period. The procedures followed, and the pattern of self-control established, are described below.

Constitution and Rules

The purpose of the Exchange is to provide a securities marketplace where high standards of honor and integrity shall prevail and to promote and maintain just and equitable principles of trade and business. (Article I of Constitution, Section 2.) To carry forward this purpose, the Constitution and the rules are designed to foster sound business practices and to outlaw acts and practices which would be inimical to the best interests of the investing public and the Exchange.

Included are provisions to outlaw fraud or fraudulent acts (Article V of Constitution, Section 4(b)); prevent acts which would tend to demoralize the market (Article V of Constitution, Section 4(d)); prohibit fictitious trades (Article V of Constitution, Section 4(c)), the spreading of rumors (Rule 2(c)), the usurpation of confidential information (Rule 3(d)), and excessive dealing by members (Rule 3(a)); outlaw fraudulent and manipulative activities with respect to securities traded on the Exchange (Rule 4); and regulate the general conduct of members and performance of specialists and floor traders (Rules 101-222).

Many of the rules (e.g., Rules 4, 107 and 174) have their counterpart in the Securities Exchange Act of 1934 (see Exchange Act Section 9, Rule 10a-1(d)(6) and Section 11(b), respectively).

In April 1936, the S.E.C. suggested the adoption by exchanges of certain rules to govern the conduct of specialists and other members. Some were designed to curtail manipulative activity and some were of a bookkeeping nature. Specialists were required to be registered as such with the Exchange and to maintain records of all orders placed with them. Two of the rules were directed at pool operations. Another made it unlawful for a specialist to participate in a joint account with

a non-member, while another prohibited a specialist from obtaining various kinds of options having to do with issues in which he acted as a specialist. One rule embodied the essential parts of Section 11(b) of the Act dealing with a specialist's transactions as a principal by limiting such transactions to those necessary to maintain a fair and orderly market. All of these suggested rules were immediately adopted by the American Stock Exchange and are an integral part of its enforcement program. (See Exchange Rules 3, 103, 150, 153, 170, 174, 175, 180, 200, 203 and 362.)

In March 1937, the S.E.C. issued to all Exchanges an interpretation by David Saperstein, Director of its Trading and Exchange Division, to effectuate certain proposals related to the functions of broker-dealers on the stock exchange (Securities Exchange Act of 1934, Release No. 1117.). This interpretation embodies the restrictions on specialists' activities recommended in the Commission's Segregation Report forwarded to the Congress on June 20, 1936. The Saperstein Doctrine has been adopted by the Exchange and has been a part of its philosophy in regulating the activities of specialists since 1937. (See Rule 174.)

In the years since the enactment of the Securities Laws and as experience has dictated, the Exchange, partly on its own initiative and partly in cooperation with the S.E.C., has adopted various other rules, regulations and policies governing the business conduct of members, specialists and floor traders designed not only for the purpose of providing increased regulation of the internal business relationships between members, but also for the greater protection of the public. (See, among others, Rules 110, 111, 133, 152, 154, 170, 175, 186, 187, 188, 190.)

Enforcement Program

Under Article II, Section 2 of the Constitution, the President and duly authorized personnel have the power to examine the books, papers and records of any member or employee thereof and to require the production of such books, papers and records for the purpose of examination. (See also Article II, Section 3—appointment of Special Committee to conduct examination or investigation.) The President and staff can also compel a member to appear and testify as to any matter or transaction pertaining to the business of such member.

The President has delegated to certain officers of the Exchange and other designated persons the responsibility of conducting investigations and inspections to determine whether members are adhering to the Constitution and the rules or policies adopted thereunder. Generally speaking, the Exchange's over-all enforcement program can be divided into three categories:

(1) Investigations;

(2) on-floor and market surveillance;

(3) office procedures and examinations.

Investigations

The Exchange Investigations Section functions under the control of a Director who in turn is under the supervision of the Vice President in charge of the Operations Division.

The Investigations Section, as the focal point of the enforcement program, conducts investigations when information obtained from members, the staff, the public or others indicates a possible violation of the Constitution, rules or policies.

Sources of Basic Information

The principal sources of information which may initiate an investigation include the following:

(1) Information obtained from the Market Procedures and Surveillance Department, including the Market Surveillance Unit. (see "Market Surveillance", below.)

(2) Information obtained from the Procedures and Examinations Department, including the Examiner's Unit. (see "Office Examinations Procedure", below.)

(3) Information received from Exchange members and member organizations.

(4) Information received from governmental regulatory bodies, other exchanges and newspapers.

(5) Inquiries from the public.

The two categories of investigations are "Investigation Assignments" and "Complaints". The latter normally emanate from the public and the most usual matter relates to the handling of a customer's account by a member organization. This type of investigation is changed to an "Investigation Assignment" if the inquiry or complaint indicates a violation may be involved.

Investigation Assignments

When it appears, after preliminary investigation, that a substantial violation may have occurred, an Investigation Assignment is opened with a memorandum outlining briefly the origin, nature and scope of the activities which tend to indicate a possible violation. It includes general instructions as to the methods to be employed in conducting the investigation. The investigation procedure includes, but it is not limited to, the following:

(1) Checking the Exchange central files for past investigation matters, if any, relating to the persons, firms or matters involved.

(2) Obtaining and examining pertinent records and documents available at the Exchange.

(3) Obtaining and examining pertinent records and documents available at the offices of member organizations.

(4) Obtaining and examining any additional information that may be considered pertinent from such other sources as are available.

(5) Interrogating persons involved and others under the jurisdiction of the Exchange who may be able to supply information.

(6) Periodic conferences by the investigator(s) with the Director of the Investigations Section.

(7) Preparation of a Report of Investigation, which sets forth the origin of the assignment, the facts uncovered, the conclusions and the recommendation.

(8) The Report of Investigation, if approved by the Director of the Investigations Section, is then given to the Vice President in Charge of the Operations Division for review and consideration by him and for such further action as may be appropriate.

Complaints

As mentioned above, inquiries from the public concerning dealings with member organizations constitute a major source of information. The Investigations Section gives careful consideration to this information and, if it appears that any infraction of the Exchange's Constitution, rules or policies may have occurred, an investigation is undertaken.

Such complaints are processed as follows:

(1) Receipt of the complaint is acknowledged and an inquiry begun.

(2) Statements which may be verified by a review of the Exchange records and files are checked.

(3) The substance of the complaint is then reported by letter to the member organization involved, requesting a written comment together with copies of pertinent records.

(4) If a registered representative or other employee of the member organization is involved, a written statement of the facts may also be requested from him. If circumstances warrant, information is obtained concerning other complaints of a similar nature the member organization may have received. The member organization may be requested to determine, if possible, what experience other customers of the employee may have had, and to forward this information to the Exchange. In appropriate cases, the Investigations Section may interview the firm's customers.

(5) Should there be no basis to continue the inquiry, the complainant is sent a letter explaining the facts and circumstances.

(6) If the inquiry indicates the firm, or anyone under the jurisdiction of the Exchange, was or may have been in violation of the Exchange's Constitution, rules or policies, an Investigation Assignment case is opened and a further investigation is made as described above.

On-Floor Surveillance

A Vice President in charge of Market Procedures heads the staff operations on the floor and works closely with the Chairman, twelve Floor Governors and twelve other Floor Officials appointed with Board approval. As possible rules violations, unusual transactions or questionable performances by specialists or other members appear, they are analyzed and marked for prompt attention. If the matter is relatively simple, it is referred to a special unit responsible for producing an analysis of the facts and an appropriate recommendation within 48 hours. Action is then taken. It may consist of a clarifying discussion or a warning by the staff, the Chairman or the Floor Governor assigned to the trading post. If the matter is more serious, the institution of a disciplinary procedure is considered promptly, as discussed below.

Market Surveillance

Market surveillance involves a constant survey of the market action of securities admitted to dealings, for the purpose of detecting any deviation from the norm which might indicate possible fraud or manipulation. The primary purpose is to help provide the best markets possible to the public. A good description of surveillance is "policeman on the beat". Every effort is made to keep abreast of changing techniques that may reveal fraud or manipulative activity.

The Market Surveillance Section observes the ticker tape to detect any unusual or unexplained price variations or market activity. The leading newspapers and periodicals, the financial news ticker, various financial publications and statistical services, together with a variety of investment advisory services and the recommendations of brokers and dealers are also closely followed. When unusual and unexplained market activity in a security traded on the Exchange is noticed, relevant information is examined. An investigation is started if the reason for a

securities movement is not readily ascertainable. The prime purpose is to uncover any evidence of improper activity. If violations by a member are established, the Exchange has appropriate disciplinary procedures which may lead to censure, fine, suspension or expulsion.

The following general areas are observed by the Market Surveillance Section for evidence of possible violations of the Exchange's Constitution, rules or policies: (1) price and volume fluctuations; (2) continuity of prices; (3) specialists' performance; (4) members' participation for their own accounts; and (5) miscellaneous factors in the market. The procedures employed are described below.

Price and Volume Fluctuations

A formula has been established reflecting the norm of price fluctuations ordinarily found in the issues traded on the Exchange. This formula is broken down into two parts. One relates to days on which the aggregate volume on the Exchange is less than two million shares, and the other relates to days on which the volume exceeds that amount. The latter formula reflects a slightly wider norm of expected price fluctuations. Those issues exceeding the applicable norm are winnowed out for examination and a daily list is prepared. Volume changes in particular issues are also checked for deviation from the norm.

The individual stocks on this list are initially examined against the separate file maintained for each issue. This file is kept up to date by inserting pertinent material. In each file there is placed all information which might in any way tend to explain the market activity of a particular security including (1) clippings from newspapers and financial magazines; (2) market letters prepared by brokerage houses; (3) recommendations by investment advisors; (4) articles on the industry or type of business of the particular company; (5) material from the Dow-Jones News Ticker; (6) information on the size of the floating supply and the short position in the issue; (7) a record of previous investigations; and (8) information on holdings by insiders.

If an examination of this data does not tend to explain the activity in the security involved, further checks are made. Statistical Manuals are checked for possible news which may not have appeared in other sources. Files in other divisions of the Exchange are examined for possible information on proxy material, mergers or take-overs. The specialist is contacted for any information he may be able to furnish.

All of these checks are conducted promptly. Absent a suitable explanation, if conditions so warrant, the Exchange may contact the company officials and ask whether they can furnish any reason for this activity. If necessary, the company will be urged to make a public release either supplying information it may properly release or, if it knows of no reason or change in the company's business to explain the activity in the security, so stating.

Normally, the next step is to check the specialist's records to determine whether there has been concentrated buying or selling. If so, the appropriate brokerage houses are called for information.

A complete breakdown of buying and selling is obtained, when necessary, from the Clearing Corporation sheets. These sheets, prepared daily, supply the names of all member houses who clear securities traded on this Exchange. These records enable the Exchange to spot any undue or unusual concentration of purchases or sales through any one brokerage house or combination of houses.

At this point, all of the material is reviewed and a decision is reached as to whether the information then available either explains the movement in the stock or whether the matter should be transferred to the Investigations Section for more extensive investigation as described above.

Continuity of Prices

A daily check is made of the Fitch Sheet, which sets forth in chronological order the prices and volume of all individual transactions in each stock. This examination pinpoints unusual variations between successive trades. A list of the issues not meeting the continuity standards is prepared for further checking.

Another list showing sales and quotations for each of the questioned securities, time stamped, is obtained from the Exchange Record Room, which is the depository for all price material and quotations. The quotations are compared with the transactions in order to determine whether the quoted market changed to a degree that would account for the questioned price variation. Should this fail to justify the price change, the Specialist's transactions are checked in relation to his duty of maintaining a fair and orderly market with proper continuity of price.

Specialists' Performances

Rule 191 requires every specialist to file a report on the following trading day covering each purchase and sale (round and odd-lots) effected for his own account. All round lots are timed. When continuity or some other phase of a specialist's activity is questioned, the trading for the period involved is reconstructed by using material from both the Exchange Record Room and the 191 Report. A study of the result will show whether or not a specialist has been properly performing his functions. In order to ascertain whether or not a specialist is filing a correct 191 Report, his report is checked against a form known as the 1-HR Report which is filed on a weekly basis by all specialists.

Rule 174 in effect limits a specialist dealing for his own account to transactions reasonably necessary to maintain a fair and orderly market and is based on one of the sixteen rules suggested by the S.E.C. to the Exchange in 1936, as mentioned above. Compliance with Rule 174 is determined by analyzing the material filed under Rule 191. Each specialist is expected to add orderliness to the market, moderate temporary disparities in supply and demand and contribute liquidity and depth by participating where necessary.

The specialists' activities are under constant observation both by the staff and by the Floor Officials of the Exchange. Extensive studies are made of any specialist's activities when it appears the markets in which he specializes do not meet the Exchange standards. Adverse findings result in appropriate action by the Exchange.

The Market Surveillance Section also receives information pursuant to Rule 177, which requires every specialist to report any unusual activity, material information, options or unusual transactions in any security in which he specializes. The information thus received is also checked for possible violations.

Floor Traders' Participation

Floor traders operate under Rule 110 of the Exchange. Although there are many prohibitions embodied in the rule, the Market Surveillance Section, as such, is principally interested in the provisions precluding congregating in or dominating the market of a particular stock. Whenever a staff examination of activity is carried out in a particular stock, a check of floor traders' activity in the stock is included. This is done to ascertain whether or not floor traders may have unduly influenced the price of the security. If this has occurred, such findings are immediately turned over to the Investigations Section for further action.

Floor traders are required to file a Form MT for any day on which they effect a trade in any security on the floor of the Exchange. Form MT shows the necessary information to

determine whether or not the floor trader has stayed within the requirements of Rule 110. After the initial check has been made, the MTs are filed away chronologically to be available for other surveillance checks.

Several checks and comparisons have been instituted to be certain the reports filed by traders are accurate. These MT Forms are checked against the Form 1-HR mentioned above in connection with specialists, since floor traders also are required to report all transactions on a weekly basis. In addition, all clearing brokers report on a weekly basis transactions cleared by them for a floor trader. The MT reports are compared with this material as a further check on the accuracy of their reporting. Spot checks are also made by obtaining floor traders' brokerage accounts for checking against their MT forms.

Miscellaneous Areas

All member organizations are required to file with the Exchange on a monthly basis the total short interest position held in all accounts for each stock traded on the Exchange. An aggregate short position for each stock is reached by totaling the amounts sent in by all member organizations, and these positions are in turn scrutinized for their effect in relation to the floating supply of the stock available for trading in the market. If necessary, member firms are required to file short position information on a weekly or even daily basis.

When it appears that the floating supply in an issue may possibly reach the danger zone, the Market Surveillance Section calls this to the attention of Exchange officials who may then take such action as may be deemed appropriate and within the authority of the Exchange.

In any case where the short interest in a stock equals 20% of the floating supply, the situation is brought to the attention of the full Board of Governors for discussion of any appropriate action.

Examinations and Inspections

The examination and inspection program provides for regular and periodic inspections of members. The inspection procedures outlined below are useful enforcement weapons to protect public investors and to detect violations of the Exchange's Constitution, rules or policies. The program is designed to protect public investors through continuing and detailed checks on the financial stability and the standards of business ethics of members and member organizations of the Exchange.

Procedures

The inspection, among other things, determines a member's financial condition, reviews and analyzes member pricing practices, evaluates the safeguards employed by members in the handling of customers' funds and securities, etc. The Exchange's examiners also determine whether members are keeping appropriate books and records, conforming to the margin and other requirements of Regulation T of the Federal Reserve Board and whether there is excessive trading or switching of customers' securities.

When the inspection discloses that a member is violating the Exchange's Constitution, rules or policies, consideration is given to the type of violation and the effect on the public. Where the violation appears to be inadvertent, the member is advised of the violation and instructed to correct the improper practices. If the violations appear to be of a more serious character, the basic information uncovered by the examination and inspection program is turned over to the Investigations Section for a thorough investigation.

Exchange Rule 446 prescribes the minimum net capital which must be maintained by members and member organizations. Rule 466 (for members and member firms) and Rule 467 (for member corporations) provide the basis for determining net capital and aggregate indebtedness. These rules are deemed by the Securities and Exchange Commission to impose requirements more comprehensive than Rule 15c3-1 under the Securities Exchange Act of 1934.

In carrying out its functions as a self-regulating authority, the Exchange has established other rules, policies and procedures designed to insure member compliance with minimum capital requirements. All members and member organizations are required by the rules to notify the Exchange promptly when net capital or the ratio of aggregate indebtedness to net capital does not meet the minimum standards of the Exchange.

Rule 443 requires all member organizations to have an annual audit by independent public accountants. Exchange policy requires that the audit date must be fixed by the independent accountant without prior notice to the member organization. In the conduct of the audit, the accountant must comply with the regulations prescribed by the Exchange which are identical with those prescribed by the Securities and Exchange Commission pursuant to Exchange Act Rule 17a-5.

In addition, all member organizations which are not also members of the New York Stock Exchange are required to file two unaudited financial statements during the calendar year as of dates selected by the Exchange.

All financial statements required to be filed with the Exchange are promptly and carefully analyzed by staff examiners, who make computations of net capital and aggregate indebtedness to ascertain compliance with the rules.

In addition, following the receipt and analysis of the above-mentioned unaudited financial statements, a field examination of the books and records of each reporting member organization is made by the Exchange. The program developed for use in these examinations provides for checking (a) of the accuracy and the proper classification of the amounts reported in the financial statement, (b) that books and records are maintained on a current basis, and (c) that the ledgers and accounts maintained conform with the record-keeping requirements of Exchange Act Rule 17a-3.

The examination is not limited to substantiating financial accounts. Mindful of the importance of the financial responsibility of its members, the Exchange is also concerned that their practices and procedures in the handling of public customer accounts conform to high standards. To that end, general office procedures, systems of internal control for the safekeeping of customers' securities and compliance with S.E.C. regulations and Exchange requirements are reviewed. Various aspects of office procedures are investigated such as:

(a) Are the pertinent provisions of Regulation T of the Federal Reserve Board and the minimum margin requirements of Exchange Rule 462 observed in the conduct of customers' accounts?

(b) Do the files contain information relating to customers and is the member complying with Rule 411 ("Know Your Customer")?

(c) Are borrowings against customers' collateral limited to the indebtedness of customers?

(d) Are customers' fully-paid-for securities or excess securities properly segregated?

(e) Are mark-ups on principal transactions with customers reasonable?

(f) Is there any evidence of "churning" in customers' accounts?

(g) Are order tickets properly marked as required by Exchange Rule 153?

(h) Is insurance coverage in effect as required by Exchange Rule 330 and prescribed by Exchange Circular J-38?

In addition to its supervision of members and member organizations dealing with the public, and in addition to the continuing surveillance of floor activities of the specialists on the Exchange as described above under "Market Surveillance", the Procedures and Examination Department conducts a periodic examination of the specialist's financial position and seeks pertinent information relating to his business activities off the floor.

In addition to the specialist's technical qualifications, the Exchange imposes a minimum financial requirement under Rule 170. This rule requires every specialist to maintain a cash or liquid asset position of $50,000 or an amount sufficient to assume a position of ten trading units of each security in which he is registered as a specialist, whichever amount is greater. The Special Study has noted favorably the 1962 amendment of Rule 170 bringing the capital requirement to its present level.

All individual members of the Exchange who are registered specialists are required to file three financial statements with the Exchange during each calendar year as of dates selected by the Exchange.

Staff examiners make field examinations following the filing by specialists of their financial statements. A program for examining transactions and activities of specialists is used in the field examinations and, in addition to the verification of capital, the following matters are also investigated:

(1) Have off-board transactions in specializing securities been effected in contravention of Rule 187?

(2) Have any transactions been effected in puts, calls, options, etc., in contravention of Rule 175 (a)?

(3) Has the specialist made any transactions in any accounts in which he is directly or indirectly interested, in any securities traded at a different section of his Post in contravention of Rule 188?

(4) If the specialist has introduced any accounts to another clearing firm, were such accounts reported to the Exchange as required by Rule 190 (b)? If such accounts contained transactions in stocks in which he is the registered specialist, were such transactions reported to the Exchange in compliance with Rule 190 (c)?

(5) Has the specialist had any direct or indirect business transactions with a company or officers or directors of a company in whose stock he is registered as a specialist which are prohibited by Rule 190 (a)?

(6) Are the positions reported by the specialist daily, as required by Rule 191, in agreement with the positions shown in ledger accounts?

At the conclusion of all field examinations by staff examiners, a written report setting forth the results of the examination is prepared. Any deficiencies or irregularities noted during the course of the examination are outlined in the report, and are referred to the Investigations Section described above for appropriate further action.

Disciplinary Procedures

Following the completion of the investigative work by the staff sections discussed above, any matter involving more than a minor, unintentional infraction is prepared for submission either to the full Board of Governors or to the Advisory Committee of the Board, depending on the nature and extent of the possible violation.

The revised Constitution lodges authority for disciplining the membership with the Board of Governors. The most serious infractions of the Constitution, rules or policies are presented to the Board in the form of written charges which may be answered, also in writing, by the accused member. At a meeting of the Board the charges are explained and the accused is afforded a full opportunity to appear personally, to examine and cross-examine all the witnesses produced before the Board, and to present such testimony, defense, or explanation as he may deem proper. If the Board determines that a violation has occurred, it may censure, fine, suspend or expel the guilty member.

The Board may suspend a member for as many as 60 days and levy fines up to $5,000 under a summary procedure which provides the accused an opportunity to state his position to the Board, but does not involve written charges.

All findings by the Board of Governors in disciplinary matters are final and conclusive.

The Constitution empowers the Board to delegate limited disciplinary authority to the Advisory Committee. The decision of the Committee must be reported, in every case, to the Board which may modify or reverse the Committee's decision. Under this authority, the Board has empowered the Advisory Committee, subject to review by the Board, to take the following disciplinary actions:

(1) Authorize a letter of admonition signed by the Chairman of the Board;

(2) censure a member before the Advisory Committee;

(3) recommend a censure before the full Board of Governors;

(4) suspend floor trading privileges for a member's own account for a period of not more than 90 days for violating the floor trading rules;

(5) suspend a specialist's registration for not more than 90 days;

(6) levy a fine of no more than $500 for each offense.

A member subjected to disciplinary action by the Advisory Committee is always reminded of his right of appeal to the Board of Governors from an action taken by the Advisory Committee.

The Constitution also provides that the Advisory Committee may fine a member a maximum of $100 for a breach of decorum or similar offense on the floor of the Exchange. The Board has approved a summary procedure for handling matters of this kind. Under this procedure, there is no written charge, no investigation and no public announcement of the Committee's action. The member has a right to appeal to the full Board. Offenses of this kind calling for stricter penalties (in excess of a $100 fine) are subject to the more elaborate procedures now followed and to Board review whether or not the member exercised his right of appeal.

In addition to these various disciplinary procedures, the Chairman may from time to time reprimand a member for his failure to meet Exchange standards.

The Board of Governors has adopted, in principle, a policy of making the results of disciplinary actions public in appropriate cases. The policy has been further developed, as follows:

(1) When a member or allied member is suspended or expelled, after a hearing, an announcement is made from the rostrum overlooking the trading floor and followed immediately by notices over the ticker system and on the bulletin board, with a simultaneous release to the public press.

(2) When a penalty less than suspension or expulsion is imposed following a hearing, the Board determines whether an announcement should be made from the rostrum overlooking the trading floor and on the ticker, or simply by a bulletin board notice.

(3) When a summary procedure before the Board results in a disciplinary action, or disciplinary action is taken by the Advisory Committee, the Board determines whether, and in what form, there should be a public announcement to the Exchange.

An announcement would be considered if the Board found:

(a) The offense was committed under such circumstances as to indicate disregard for the well-being of the Exchange;

(b) the offense was of such proportion as to reflect adversely on the integrity of the offender;

(c) the offense resulted in a substantial impairment of the financial condition of the offender and damaged, or may have damaged, those with whom the offender was doing business;

(d) the offense, without question, caused a member of the public to suffer more than a minimal financial loss; or

(e) the offense involved a violation of the federal or state securities laws.

Disciplinary actions which are not announced, except for minor violations of internal administrative or conduct rules, are ordinarily described in general terms, through information circulars distributed to the membership, if the circumstances are unusual and of general interest.

Since September 4, 1962, the Exchange has undertaken 131 investigations, of which 111 have been completed. Summaries of the completed investigations have been presented to the Board of Governors with copies to the S.E.C., whether or not disciplinary action resulted.

During the same period, major disciplinary action has been taken against 20 members and allied members and announced publicly. Penalties ranged from fines and censures to suspensions and an expulsion. Prior to September 4, 1962, but following the issuance of the S.E.C. Staff Report on the Exchange, other disciplinary actions were taken and announced as noted in Chapter XII-C of the Special Study issued this summer.

PART III

SUMMARY OF CONSTITUTION AND RULES WITH COMMENTS ON RECOMMENDATIONS OF SPECIAL STUDY AND COMMISSION

There are 450 provisions of the Constitution and rules of the Exchange summarized in this part. Those deemed to relate directly to the protection of investors are marked by asterisks.

A substantial number of the 176 formal recommendations made by the Special Study, including some adopted in principle by the Commission, relate directly or indirectly to provisions of the Exchange Constitution or rules adopted by the Board of Governors.

Special Study recommendations and comments, and Commission comments, are summarized following the Exchange provisions to which they relate directly or indirectly. These summaries are followed by comments of the Exchange, based on its study to date.

Many of the recommendations and comments involve complex areas requiring analysis of market data and procedures, costs, problems of administrative feasibility, technological advances, and a study of the various types of business of the membership. The comments of the Exchange are as forthright and complete as possible at this time, but further study and reflection is necessary in some areas and may prompt the Exchange to alter its opinions.

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CONSTITUTION OF THE AMERICAN STOCK EXCHANGE

ARTICLE I

TITLE—PURPOSES—DEFINITIONS

Section

Section 1—Title

1 Names the Exchange.

Section 2—Purposes

*2 Sets forth purposes: to provide a securities market place where high standards of honor and integrity shall prevail and to promote and maintain just and equitable principles of trade.

Section 3—Definitions

3 Defines "rules of the Exchange", "member" and "allied member", "member firm" and "member corporation", "voting stock", "non-voting stock", "security" or "securities", "Member Contracts", "Exchange Contracts" and "date of death".

ARTICLE II

GOVERNMENT AND ADMINISTRATION

Section 1—The Board of Governors

*1(a) Classifies 32 Governors into 12 member New York Floor Governors (6 of whom are not from specialist firms), 10 office New York Governors, 5 office out of town Governors, 3 public representatives and the Chairman and President. Governors are selected by vote of regular members, except 3 public Governors are appointed by President subject to Board approval. Floor trading and gratuity fund rights of non-regular-member and public Governors are limited.

*1(b) Empowers the Board of Governors to regulate business conduct of members, promote the purposes of the Exchange, pass rules, determine procedures, control finances, delegate powers, hear appeals, and establish a Special Committee in emergency. Provides for meetings, regular and special, and action thereat. Provides for quorum of 9 Governors.

Empowers the Board to authorize employment contracts, elect a President, elect a Vice Chairman of the Board, select general counsel, try members, require transactions in which members participate in securities admitted to dealings to be made on the Exchange, prescribe and impose penalties for violations of rules, prescribe rules for dealings on the Exchange, list or admit to unlisted trading securities upon the Exchange, provide for fair settlement prices where securities are cornered, invite non-governors to attend meetings, and supervise members, member firms and member corporations.

Disqualifies Board member from participation in determination of any matter in which he has a personal interest.

Section

Also empowers the Board to adjourn a hearing or trial, interpret the Constitution and Rules of the Exchange, cause the organization of any corporation to facilitate the business of the Exchange and authorize a group hospitalization plan.

Section 2—Officers of the Exchange

*2(a) Designates the Chairman as presiding officer of the Board. Subject to Board approval, he shall appoint and may remove members of the Advisory Committee and shall be ex officio a member thereof.

*2(b) Sets forth the duties of the Vice Chairman.

*2(c) Designates the President the principal officer and chief executive, responsible to the Board for the management and administration, without other business interests. The President has the power to examine the books, papers and records of any member, to cause any member to appear and testify before him, to appoint public governors not engaged in the securities business, to appoint committees, officers and other employees who shall be responsible to him, and determine their numbers and duties. The President shall report on finances.

2(d) Requires the Treasurer to take charge of and disburse monies.

*2(e) Requires the Secretary to keep records of Exchange, Board and members.

2(f) Deals with precedence in case of absences.

Section 3—Committees

*3(a) Authorizes an Advisory Committee to be composed of 7 Governors who shall assist with the administration and interpretation of the Constitution, Rules and the policies promulgated by the Board.

*3(b) Empowers any committee authorized by the Board to examine and investigate the records of any member or his employee and any matters and transactions pertaining to their business.

3(c) Empowers the chairman of any committee authorized by the Board to appoint certain classes of members to serve with the approval of the President.

3(d) Empowers committees to regulate matters within their jurisdiction.

3(e) Authorizes each committee established by the Board to determine the conduct of its proceedings.

Section 4—Indemnification

4 Empowers the Board to indemnify any person named therein against all liabilities and expenses incurred in connection with the defense of any proceeding to which he has been made a party.

ARTICLE III
ELECTIONS—NOMINATIONS

Section 1—Annual Election—Positions to be Filled

1 Designates the time of and positions to be filled at each annual election.

Section	
	Section 2—Tie Vote
2	Sets forth the procedure in the event of a tie vote.
	Section 3—Limitation on Service
*3	Limits the number of consecutive terms a Governor or Chairman can hold office.

	Section 4—Right to Vote
*4	Entitles each regular member to vote at elections and on Constitutional amendments and to petition for independent nominations.

Special Study Recommendation: Allied members of N.Y.S.E. firms (general partners and holders of voting stock) should have full or partial voting rights. (Recommendation 2, Ch. XII—B, p. 576.) The recommendation applies to the A.S.E. by analogy.

Special Study Comment: The financial interest of allied members exceeds, in many cases, the interests of partners or holders of voting stock who are members of the N.Y.S.E. The present system whereby only regular members have a vote is not an accurate reflection of the true ownership interests in member organizations.

Commission Comment: "With regard to the organization of the Exchange [N.Y.S.E.], 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." (Transmittal Letter, August 8, 1963, Part 4, p. VI.)

Exchange Comment: The Exchange is an unincorporated membership association. There may be legal problems which would preclude granting the right to vote on certain matters to those who do not have a proprietary interest in the Exchange.

In the course of its reorganization, the Exchange has reviewed and changed the composition of its Board of Governors as well as its procedures for nominating candidates for the Board. The goal has been, and will continue to be, to assure a balanced representation on the Board of different segments of the business and different parts of the country. The specific recommendation of the Special Study calls attention to a complex matter, but may suggest an over-simplified approach.

	Section 5—Ineligibility
*5	Provides that no suspended member shall be eligible as a nominee for office.
	Section 6—Nominating Committee
*6	Sets forth the independance of and limitations for membership on the Nominating Committee.
	Section 7—Procedure for Nomination
*7(a)	Requires all candidates for election to be nominated by the Nominating Committee or independently.
7(b)	Requires the Nominating Committee to hold at least two meetings not less than one week apart in November.

Section	
*7(c)	Sets forth the standards for the Nominating Committee, giving emphasis to business in which the public is directly interested.
7(d)	Requires the Nominating Committee to report its results at least five weeks prior to the annual election.
7(e)	Deals with substitute nominees.
*7(f)	Sets forth the procedures for independent nominations.

Section 8—Election Rules

8(a)	Empowers the Board of Governors to prescribe election rules.
8(b)	Requires an election to be held on a full business day.
8(c)	Sets forth the times on election day when votes must be cast.
8(d)	Requires the Chairman of the Board to appoint three tellers of election to receive and count the ballots and to report the results.

Section 9—Vacancies

9(a)	Defines vacancies.
*9(b)	Provides that the Board may dismiss a Governor for absence from three consecutive regular meetings.
*9(c)	Provides that the expulsion, suspension or insolvency of a person holding office shall create a vacancy in that office.
*9(d)	Sets forth grounds for removal.
9(e)	Provides for filling vacancies on the Board.
9(f)	Empowers the Board to fill vacancies in offices to which the holder is elected by the Board.

Section 10—Exchange Quorum

10	Provides that a majority of the regular members shall constitute a quorum.

Section 11—Special Election

11	Deals with special elections.

ARTICLE IV

MEMBERSHIP

Section 1—Admission to Membership

*1(a)	Sets forth standards for the admission to, and the number of, regular memberships.
*1(b)	Sets forth standards for admission to allied membership as well as their rights and responsibilities.
*1(c)	Sets forth standards for admission to associate membership as well as their rights and responsibilities.

Special Study Recommendation: Standards for entry into the securities business should encompass competence (in the sense of knowledge and experience), character, integrity and financial capacity and responsibility. (Recommendation 6, Ch. II—F, p. 160.) (This recommendation also applies to Article IV, Sections 1 (a), 1 (b), 2 (j), 2 (r), 2 (s) and Article II, Section 1 (b).)

Special Study Comment: While there have been significant accomplishments in all these areas, there are serious gaps and deficiencies that need to be remedied promptly. Among these are the inadequacies of present examinations that measure competency, the lack of experience requirements for specific jobs, the inappropriate distinctions for full time or part-time salesmen, and the need to form local "character and fitness" committees.

Commission Comment: This recommendation was approved at p. 4 of S.E.C. Special Market Study Release No. 25, April 30, 1963, and is reflected in H.R. 6789, Section 7(a)(3).

Exchange Comment: While the Special Study's recommendation is primarily in the context of the N.A.S.D.'s area, the Exchange's support of H.R. 6789 reflects its agreement in principle. The difficulty of defining the concepts of competence, character and integrity, points, however, to the need for caution to avoid arriving at inflexible standards and procedures to be followed.

These concepts are embodied in the Exchange Constitution (Article II, Section 1 (b), Article IV, Sections 1 (a), 1 (b), 2 (j), 2 (r), and 2 (s)), and in the Exchange's established policies and practices. Application forms for membership and forms for employment of registered representatives are designed to obtain information which bears on experience, character and integrity. The established examination program tests knowledge. Each regular member applicant must, at the time he applies, be responsible to the extent of at least $10,000 in cash or liquid assets, over and above the cost of his membership. With further respect to financial capacity and responsibility, Rules 446, 466 and 467 expressly impose minimum standards which are, in the opinion of the Exchange, adequate to help safeguard investors.

Section	
1(d)	Limits liability of Exchange to members using Exchange facilities.
1(e)	Requires payment of initiation fee.
	Section 2—Members, Member Firms and Member Corporations
*2(a)	Prohibits the formation of a member partnership without Board approval.
*2(b)	Prohibits the formation of a member corporation without Board approval.
*2(c)	Requires general partners or voting stockholders of regular member organizations to be regular or allied members.
*2(d)	Sets forth the conditions of approval of member corporations.
*2(e)	Sets forth the grounds for withdrawal of approval of member corporations, including violation of Exchange Rules.
*2(f)	Prohibits a member from being associated with a former member corporation without the consent of the Board.
*2(g)	Provides that the approval of an organization as a member organization can be revoked.

Section	
*2(h)	Requires every member organization to register an address with the A.S.E.
*2(i)	Requires member organizations to obtain A.S.E. consent to establish branch offices.
*2(j)	Empowers the A.S.E. to disapprove the employment and remuneration or term of employment of any employee, branch office manager or officer of a member organization or require the termination of employment of any such employee or officer.
*2(k)	Requires a member to notify the A.S.E. of an intention to form a partnership or member corporation.
*2(l)	Prohibits the assignment or encumbrance of membership or interest in member organization without Exchange approval.
*2(m)	Requires member organization to submit information as to proposed changes in that organization.
*2(n)	Requires notice of retirement from a member organization.
2(o)	Requires every partner or stockholder in a member organization to have a determinable interest therein.
*2(p)	Prohibits a member firm from doing business with the public unless it has at least two general partners active in the business.
*2(q)	Limits affiliation to one member organization.
*2(r)	Prohibits a member from forming a business with a suspended member or expelled member, an insolvent person or a minor.
*2(s)	Denies membership to member permitting expelled member to remain associated with his member organization or suspended member to participate in profits of or act for his member organization.
2(t)	Requires the affirmative vote of two-thirds of the Governors present whenever their action is required under Section 2.
	Section 3—Member Representatives
3(a)	Authorizes the Board to permit a regular member elected prior to June 1, 1923, to have a salaried floor representative.
3(b)	Allows a regular member Governor to have a representative on the floor during the time he is engaged in A.S.E. business.
*3(c)	Allows a regular member to designate another regular member as his representative on the floor during his absence on A.S.E. business.
3(d)	Allows a regular member to designate an allied member or employee of a regular member as his representative on the floor while actively engaged in military or other public service for defense of the United States.
3(e)	Allows a regular member to designate an allied member or employee of a regular member as his representative on the floor while actively engaged in military training for a period not exceeding thirty days.

Section	
3(f)	Empowers the Board to withdraw any authorization given pursuant to this Section.
*3(g)	Deems contracts made by any representative authorized pursuant to this Section, contracts made by the regular member.
	Section 4—Transfer of Membership
*4(a)	Prohibits transfer of membership while charges are pending or before acceptance of written resignation by Board.
*4(b)	Limits the transfer of a regular membership to a candidate elected by the Board.
*4(c)	Prohibits a prospective transferor from making any contracts within four days of the proposed transfer and governs closing thereof.
*4(d)	Deals with the application and distribution of the proceeds from the transfer of a regular membership, and limits transferor to surplus after satisfaction of designated creditors.
4(e)	Deals with the procedure for filing claims against the proceeds of a transferred regular membership.
4(f)	Subordinates intra-partnership or intra-corporate claims to payment in full of all other claims allowed by Board of Governors.
4(g)	Deals with disposal by Board of membership of expelled member.
*4(h)	Preserves rights of creditors under this Section upon the death, expulsion, suspension or resignation of regular member.
4(i)	Preserves rights of estate of deceased creditor-member against proceeds of membership of debtor-member under this Section.
	Section 5—Reinstatement
*5(a)	Requires approval of the Board for reinstatement of a suspended member.
*5(b)	Deals with the procedure for reinstatement and requires list of creditors.
*5(c)	Provides that the Board may declare ineligible for reinstatement any suspended member guilty of irregularities or unbusinesslike dealings.
	Section 6—Temporary Member Firms and Corporations
*6(a)	Empowers the Board to grant the status of temporary member organization upon the death of the sole regular member in that member organization.
*6(b)	Conditions status of temporary member firm on continuance of business, filing of agreement, and adequate capital.
*6(c)	Conditions status of temporary member corporation on continuing business, holdings of voting stock, agreement of decedent, and adequate capital.
*6(d)	Extends to temporary member organization most rights and privileges of regular member organizations, except floor privileges.
*6(e)	Vests organization with temporary membership status on filing application following death of the regular member.

Section	
6(f)	Empowers the Board to terminate temporary membership.
6(g)	Subjects the proceeds of sale of a regular membership, the use of which has been contributed to temporary member organization, to certain claims.

Section 7—Disposal of Regular Memberships by the Board

7(a)	Empowers the Board to retire regular memberships under this Section.
7(b)	Empowers the Board to transfer to the Chairman, as trustee, any regular membership which has been suspended for ninety days for non-payment of A.S.E. dues, fines, and so forth.
7(c)	Provides that the owner ceases to be a member on transfer of membership to trustee.
7(d)	Provides procedure for sale and distribution of proceeds of memberships under this Section.
7(e)	Retires memberships transferred to the A.S.E. under this Section.
7(f)	Immunizes trustee from liability.
7(g)	Requires notice of offering price of memberships under this Section.

ARTICLE V

DISCIPLINE OF MEMBERS

Section 1—Procedure

*1(a)	Requires members to submit to examination by another exchange where the Board deems same in public interest.
*1(b)	Specifies the procedures to be followed in regard to disciplinary matters brought before the Board of Governors. Provides for formal written charges in reasonable detail, service on accused, written answer, formal hearing before the Board and opportunity of accused to attend, to be heard, to examine and cross-examine witnesses and to present such testimony, defense or explanation as he may deem proper, decision as to innocence or guilt, imposition of penalty and announcement to the Exchange.

Related Exchange Provisions: Article VIII of the Exchange Constitution provides for arbitration of claims or controversies between members and between members and their customers, and establishes procedures applicable to Exchange arbitration proceedings.

Rule 222 empowers the Exchange to revoke a floor wire privilege at any time.

Rule 418 prohibits members from being associated with bucket shops.

Rule 500 requires Exchange approval of wire connections with non-members.

Rule 502 authorizes the Exchange to discontinue any means of communication and requires a member to give prompt notice of discontinuance to the Exchange.

Rule 503 requires Exchange approval of communications systems between member and non-member offices.

Rule 505 requires Exchange approval for the use of a wire system between two or more offices of a member and authorizes the Exchange to discontinue same.

Special Study Recommendations: Disciplinary matters should be handled with such formality as to provide basic fairness and, as a general procedure, should be publicly reported. (Recommendation 6, Ch. XII—B, p. 577.)

"Due process" requirements should apply to disciplinary proceedings of exchanges affecting substantial rights of members or employees, and non-members who do business with members, if possible without Exchange Act amendment. The Commission should have the right to review certain exchange disciplinary matters. (Recommendation 5, Ch. XII—I, p. 727.)

Special Study Comment: "During 1962 the [A.S.E.] made major moves in the direction of establishing a regulatory system sufficient to meet its responsibilities under the act. A new management, committed to establishing and enforcing high standards of commercial honor and integrity, assumed control of the Exchange's government. A new constitution was put into effect embodying provisions aimed at providing responsible self-government. . . . Disciplinary action was taken against members who were found to have violated Exchange rules and Federal law." (Ch. XII—C, pp. 583, 584.)

"Self-regulation as a part of the total regulatory pattern of the securities industry involves certain advantages that have been recognized since the concept was first introduced. The expertness and immediacy of self-regulation often provide the most expedient and practical means for regulation. By making those regulated actual participants in the regulatory process they become more aware of the goals of regulation and their own stake in it. In some areas the self-regulatory bodies can promote adherence to ethical standards beyond those which could be established as a matter of law." (Ch. XII—I, p. 722.)

Commission Comment: "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." (Transmittal Letter, August 8, 1963, Part 4, p. IX.)

Exchange Comment: The Exchange's disciplinary procedures are detailed earlier in Part II of this Statement. The Exchange believes that the disciplinary procedures provided for under Article V are adequate to enable the Exchange to fulfill its function as a self-regulatory agency in supervising the conduct of its members and in meeting its obligations under the Securities Exchange Act. Disciplinary procedures are, in practice, so conducted as to insure the accused of a fair hearing at all times. The results of such disciplinary actions are publicly reported in the manner deemed appropriate by the Board, having regard to the nature and seriousness of the particular violation. The policy established is stated in Part II of this statement.

The disciplinary procedures provided for in the Exchange Constitution, and as administered by the Exchange, include the fundamental requirements of due process. An accused member is afforded adequate opportunity to review the charges preferred against him, to file an answer to the charges, and to be present at a formal hearing where he may testify, introduce such witnesses and present such defense or explanation as he may deem proper. The disciplinary proceeding is conducted in a formal manner but without technical evidentiary restraints applicable to a court of law; the accused member is thereby given broad latitude in presenting his defense. Hearings in disciplinary matters are conducted before Governors of the Exchange, persons themselves engaged in and familiar with the securities business in which the member makes his livelihood, together with three representatives of the public who are not in the securities business.

The Commission is advised of all Exchange disciplinary proceedings involving violations of the Exchange Constitution, rules or policies or of Federal laws, and as a matter of practice the Exchange makes available to the Commission information requested in regard to such disciplinary proceedings.

With regard to arbitration proceedings conducted under the provisions of the Exchange Constitution, the arbitrators are advised of any applicable statutory requirements and their decision as to procedural matters is made after a full consideration of such requirements.

The Exchange believes that in fulfilling its functions as a self-regulatory body it must have the authority to supervise and, if necessary, restrict or terminate relationships between its members and other firms, organizations or individuals which it determines, after due investigation, may be inimical to the best interests and welfare of the investing public, the members of the Exchange and the Exchange itself. All Exchange rules affecting such matters are of course filed with the Commission. In administering such rules the Exchange endeavors, in each instance, to conduct as complete an investigation as possible, within the scope of its authority, and limits any action taken to the extent consistent with the facts disclosed by such investigation and its authority.

Section

***1(c)** Allows the Board of Governors to impose a suspension up to 60 days or a fine up to $5,000 in an informal proceeding where the accused has been summoned before the Board, informed of the charges, and afforded an opportunity for explanation by personal or other testimony.

Special Study Comment: Efficiency and speed in disciplinary cases is a serious problem. (Recommendation 8, Ch. XII—G, pp. 681-682.)

Exchange Comment: This Section and Section 2(a) below are designed to permit efficiency and speed in lesser disciplinary cases. The Exchange believes these provisions and the procedures followed are properly designed to help it meet the goal mentioned in the Special Study.

1(d) Provides no person has right to be represented by professional counsel in hearings.

***1(e)** Prohibits a person under charges before the Board to discuss the subject of such charges with a Board member.

Section	
	Section 2—Delegation of Disciplinary Power
2(a)	Provides for the delegation of disciplinary powers over lesser infractions to the Advisory Committee. (See Exchange Comment following Section 1(c).)
2(b)	Prohibits the use of indecorous conduct.
*2(c)	Prohibits betting on the floor of the A.S.E.
2(d)	Deals with the procedures for various violations.
	Section 3—Suspension for Insolvency or Failure to Meet Engagements
*3(a)	Provides for automatic membership suspension for insolvency.
*3(b)	Provides for suspension by the Chairman if, in the opinion of the President or Advisory Committee, a member cannot safely be permitted to continue in business.
*3(c)	Empowers the A.S.E. to investigate any insolvency.
*3(d)	Empowers the Board to dispose of a membership for failure to settle with creditors or obtain reinstatement.
3(e)	Provides for suspension for failure to pay dues.
	Section 4—Suspension or Expulsion
4(a)	Establishes special quorum and vote required to suspend or expel a member.
*4(b-k)	Establishes grounds for suspension or expulsion, including: fraud, fictitious transactions, market demoralization, misstatements on material points, fraud prior to election to membership, dealings by a member on another New York exchange in securities traded on the Exchange, violations of A.S.E. Constitution, Rules or resolutions, or conduct inconsistent with equitable principles of trade, wilful violations of the Securities Exchange Act, acts deterimental to the A.S.E. and failure to testify in a proceeding before the Board.
*4(l)	Allows for fines in addition to or in lieu of suspension or expulsion.
*4(m)	Provides that expulsion shall terminate all rights and privileges of membership.
*4(n)	Provides that suspension shall terminate all rights and privileges of membership, except in Gratuity Fund.
*4(o)	Empowers the Board to proceed against a suspended member for any offense committed either before or after the suspension.
*4(p)	Makes a member responsible for the acts of his member organization as though they were his own personal acts.
4(q)	Provides that the membership of any suspended member may be disposed of by the Board for failure of a suspended member to pay dues, fines and so forth.

Section 5—Disapproval of Business Connections

Section	
*5(a)	Empowers the Board to disapprove the business connections of any member.
*5(b)	Prohibits the domination of a member by a nonmember corporation or association and empowers the Board to order the member to discontinue such business connection.

ARTICLE VI

COMMISSIONS AND CHARGES

*1	Requires members to charge not less than the minimum rates of commission prescribed in this Article on transactions in securities traded on exchange; prohibits rebates and other such arrangements, but allows members to charge, in respect of transactions made on other exchanges, the rates of commissions prescribed by such other exchanges.
2	Sets forth the schedule of stock commissions.

Special Study Recommendations: The eight recommendations in Chapter VI-I (pp. 349-351) of the Special Study concerning commission rates are for the most part directed to the N.Y.S.E. or the S.E.C., but certain of them apply to the A.S.E. by analogy.

It is recommended that the N.Y.S.E. scrutinize the lack of distinctions between types of non-members in its present non-member commission rate schedule (Recommendation 1), and the advantages and disadvantages of associate memberships (Recommendation 2); that the Commission study volume discounts (Recommendation 3) and the desirability of separate rates for basic brokerage functions and ancillary services or a schedule of maximum and minimum rates for all services (Recommendation 4); and that objective standards be established for measuring the reasonableness of rates (Recommendation 5).

It is also recommended that income and expense report forms should be filed by the member firms of all exchanges doing a public commission business, so that the Commission and exchanges can develop procedures to take account of changes in volume and determine unit costs in applying reasonable standards (Recommendation 6). It is also recommended that proposed changes in rates be submitted to the S.E.C. prior to effectiveness, and that refunds or adjustments should possibly be made in respect to increases made effective during S.E.C. review but not approved by the S.E.C. (Recommendation 7).

It is recommended that customers' confirmations of odd-lot transactions should be required to show separately the odd-lot differential and the brokerage commission (Recommendation 8).

Special Study Comment: The N.Y.S.E. non-member rate schedule has been followed with few variations by the A.S.E. and regional exchanges. Various ad hoc practices, including reciprocal arrangements and give-ups, are discussed. The Special Study did not study or comment on the level of any particular commission rate or rate schedule, but was concerned with the principles and methods of determining rates and with various practices resulting from the rate structure now in effect.

Commission Comment: ". . . any proposals regarding the structure of the New York Stock Exchange commission rate schedule must be premised upon a thorough understanding of the impact any change in that structure would have on other sectors of the securities markets, such as the regional exchanges." (Transmittal Letter, July 17, 1963, Part 2, p. VII.)

"With respect to [Recommendation 1], the Commission agrees that it should address more positive and continuous attention to the commission rate structure of the New York Stock Exchange. We accept the suggestions that studies should be made concerning: arrangements for discounts for non-member broker-dealers [Recommendation 2]; volume discounts [Recommendation 3]; and the feasibility and desirability of separate schedules for the brokerage and service components of commission rates [Recommendation 4].

"As to [Recommendations 5 and 6], the Commission recognizes that the problems involved in regulating commission rates in the securities business are far more intricate and intangible than those involved in public utility rate regulation, but that it would be desirable, to the extent possible, that the Commission's role in the rate-fixing process be more clearly articulated. The Commission agrees that the development of additional data and allocation formulae will also facilitate determination of the extent to which the establishment of objective standards for measuring the reasonableness of commission rates is feasible and useful.

"With regard to [Recommendation 7], the Commission will consider the adequacy of its arrangements with the New York Stock Exchange—developed at the time of the last commission rate increase in 1958—for supplying advance notice and information with respect to proposed increases.

"We agree with the recommendation contained in [Recommendation 8] regarding separate disclosure of the odd-lot differential and the brokerage commission in confirmations of odd-lot transactions." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 4.)

Exchange Comment: The A.S.E. is not in a position, at this time, to make more than preliminary observations on these complex matters.

The A.S.E. does have associate members, as noted earlier, providing a special rate structure for non-regular-member broker-dealers who meet Exchange standards.

The suggestion regarding volume discounts must be weighed against many factors, including the fact that securities are often held by banks, broker-dealer firms and other institutions beneficially for others. Any commission rate structure based on volume discounts and permitting bunching of orders to take advantage of such discounts could adversely affect exchange markets. Moreover, published data show that a step that would or might diminish commission income could have serious economic consequences for many firms.

The suggested establishment of standards for measuring reasonableness of exchange rates apparently is based on an analogy to the rates of public utilities. Yet exchange members are subject, as the Study points out, to increasing competition from over-the-counter dealers in listed securities and there are alternative forms of investment such as savings accounts, life insurance, real estate and unlisted securities. Accordingly, the aptness of any comparison of the exchanges to public utilities is questionable.

The suggested refund or adjustment of commission charges based on rates not ultimately approved by the S.E.C. appears to be highly impracticable. If such a suggestion were adopted, the cost of doing business might so increase that all rates would have to be higher.

The recommendation that odd-lot confirmations separately state differentials and commissions requires careful consideration from the standpoint of practical problems involved for member organizations.

Section	
3	Provides for member-rate commission to member organizations; provides for non-member commissions to be charged to each special partner's and allied member's account.
4	Empowers Board to permit member organization of member suspended for insolvency to have firm business transacted at member rates.
*5	Empowers Board to prescribe service charges in addition to minimum prescribed commissions and prohibits rebates, discounts and allowances.
6	Empowers Board to authorize commission give-ups to individual members actively engaged in military service.
7	Allows commission give-up to member organization when sole regular member is in military service.

ARTICLE VII

FEES AND DUES

1(a)	Sets forth initiation fees for regular members.
1(b)	Sets forth initiation fees for associate members.
2(a)	Sets forth the time for payment of dues and allows for apportionment of dues.
2(b)	Provides that the A.S.E., upon transfer of a regular membership, will return unexpired dues paid for by transferor and collected from transferee.
2(c)	Provides that unpaid dues at the time of transfer will be collectable from proceeds of sale.
2(d)	Imposes liability for dues until transfer of membership.
2(e)	Provides that liability for dues will cease upon transfer of membership to trustee under Article II, Section 7.
3	Imposes a fee when an associate member becomes a director or officer of a corporation qualifying for associate privileges.
4	Empowers the Board to impose a charge for members based on commissions earned.

ARTICLE VIII

ARBITRATION PROCEDURE

1	Imposes a duty to arbitrate all disputes arising between member organizations from any transaction made in the course of their business except they may choose N.Y.S.E. arbitration instead.
2	Imposes a penalty for failure to arbitrate.
*3	Encourages arbitration agreements between member organizations and their customers.

Section	
4	Authorizes the President to designate an arbitration director.
*5	Permits any party entitled to arbitration to request same.
*6	Sets forth the procedure for answering a request for arbitration.
7	Empowers the Chairman to select a panel of arbitrators.
8	Sets forth the procedure for the selection of arbitrators.
9	Authorizes the arbitration director to decide on the duty to arbitrate.
10	Deals with the arbitration director's instructions to the arbitrators.
11	Makes the arbitrator's decision final.
12	Empowers the Board to prescribe additional rules for the conduct of arbitration proceedings.
13	Requires all fees collected pursuant to arbitration to be deposited with the Treasurer and the cost of arbitration to be borne by the A.S.E.
*14	Empowers arbitrators to determine right to professional counsel.
*15	Makes the failure to pay an award made pursuant to arbitration grounds for suspension.

Special Study Recommendation: The N.Y.S.E. should reorient its handling of customers' complaints in order to determine whether disciplinary action is warranted. It should act in a self-regulatory role and not in a protective role towards its members. (Recommendation 5, Ch. XII—B, p. 577.)

Special Study Comment: The arbitration machinery of the N.Y.S.E., generally efficient and fair though it appears to be, should not be used as a substitute for or in derogation of the exercise of its disciplinary responsibilities.

Exchange Comment: The recommendation and comment may be directed to the A.S.E. by analogy. The Exchange believes its arbitration machinery and the procedures adopted under Article VIII, which are similar to those of the N.Y.S.E., are fair to both customers and Exchange members. The Exchange must avoid injecting itself in disputes of a business nature involving questions as to the customer's legal right to reimbursement, except to the extent that it can provide efficient, relatively inexpensive arbitration facilities. Questions of possible misconduct are identified, investigated, and acted upon by the Exchange in the performance of its enforcement and disciplinary function. The Exchange does not consider the arbitration procedure as a substitute for its disciplinary function with respect to members.

ARTICLE IX

The Gratuity Fund

1	Limits the Gratuity Fund to regular members only.
2	Sets forth the purpose of the Gratuity Fund.

Section	
3	Requires newly elected members to contribute $20.00 to the Gratuity Fund before being admitted to membership.
4	Requires each member to contribute $20.00 to the Gratuity Fund upon the death of another member.
5	Deals with payment of benefits.
6	Deals with beneficiaries.
7	Provides that the income of the Fund be credited annually to each member to reduce the payments under this Article.
8	Restricts the provisions of this Article to active members.
9	Entrusts the Gratuity Fund to trustees.
10	Determines the classification and selection of trustees.
11	Deals with the procedure for filling a vacancy among the trustees.
12	Limits Fund investments to the New York State Legal List.
13	Provides that the trustees elect officers of the Fund.
14	Deals with meetings of the trustees.
15	Requires reports on the condition of the Fund.
16	Deals with the management of the Fund.
17	Empowers the trustees to make payments to minors subject to such terms and conditions as they deem advisable.
18	Provides that gratuity be added to the principal of the Fund if the beneficiary cannot be located within six years.
19	Empowers the trustees to pay certain expenses out of the Fund.
20	Sets forth the procedure for filling vacancies among officers of the Fund.
21	Empowers the Board to supervise finances of the Fund.
22	Empowers the Board to discipline trustees for malfeasance or negligence in office.
23	Permits the President of the A.S.E., if a former member, to be included under the provisions of this Article.

ARTICLE X

A.S.E. Clearing Corporation

1	Empowers the Board to exercise the rights of the A.S.E. as stockholder of the A.S.E. Clearing Corporation.
*2	Requires settlement of every Exchange contract through A.S.E. Clearing Corporation with certain exceptions.
*3	Incorporates the rules of the A.S.E. Clearing Corporation into every contract which is cleared through it.

Special Study Recommendation: The industry should give continuing attention to possibilities for modernizing and improving existing securities handling, clearing and delivery systems with the goal of reducing physical transfers of securities and centralization of functions now performed by the back offices. (Recommendation 4, Ch. III—E, p. 428.)

Special Study Comment: Revision of the present rules of the self-regulatory agencies' affiliated clearing organizations should be undertaken to encourage prompt delivery. (Ch. III—E, p. 427.)

Exchange Comment: As a part of its long-range automation program, the Exchange has begun studies looking toward speeding clearing operations and inaugurating additional services not presently available. As facilities become available for additional and improved services under this program, the Exchange will review its existing rules so that it can take full advantage of appropriate automation developments.

ARTICLE XI

Miscellaneous Provisions

Section	
*1	Incorporates the provisions of the A.S.E. Constitution and Rules into all A.S.E. contracts.
2	Provides that dealings in securities admitted by N.Y.S.E. shall be terminated on the A.S.E.
*3	Requires members and member organizations to keep books and records. (See Exchange Comment following Rule 191 below.)
*4	Prohibits member organization from acting as broker for a nonmember organization controlled by it without prior written consent of the A.S.E.; limits participation in corporate commissions; limits corporate use of member office and name; imposes responsibility on member organization for corporate subsidiary; and imposes the duty to produce books.

ARTICLE XII

Emergency Committee

*1	Vests powers of the Board in an Emergency Committee in the event of attack.
2	Deals with the composition of the Emergency Committee.
3	Deals with meetings of the Emergency Committee.

ARTICLE XIII

Amendments to the Constitution

*	Every proposed amendment to the Constitution must be presented in writing to the Board at a regular meeting or at a special meeting expressly called for the purpose. The Board shall then make such changes as it deems necessary or appropriate to carry out the intention of the proposed amendment. Once adopted by the affirmative vote of seventeen Governors, the proposed amendment shall be submitted to the regular membership for approval or disapproval. Each regular member shall be entitled to one vote.

ARTICLE XIV

Provides for the effective dates of the general amendment of the A.S.E. Constitution of 1962. Additionally, it provides that the provisions of the A.S.E. Constitution in force immediately prior to the effective dates of the general amendment shall be superseded except that such amendment shall not affect the liability or rights theretofore acquired or incurred.

RULE DEFINITIONS

Definition	
1	Defines "member", "allied member", "member firm", "member corporation", "voting stock", "non-voting stock", and "holder" by reference to Constitution.
2	Defines "delivery Exchange ticket" by reference to rules of the A.S.E. Clearing Corporation.
3	Defines "delivery".
4	Defines "registered employee".
5	Defines "branch office manager".
6	Defines "registered representative".
7	Defines "he", "him" and "his" to include partnerships and corporations where context requires.
8	Defines "business day".
9	Defines "The Exchange".

I. GENERAL RULES

Rule	
*1	Limits the hours of transacting business from 10:00 A.M. to 3:30 P.M.
*2	Permits visitors to the Gallery but not on the floor unless permission is obtained.
*3	Prohibits members from: (a) making transactions which are excessive with respect to their financial resources or the market, (b) trading with an associate or nonmember in the rooms of the Exchange except to: (1) take or supply stock to fill a customer's order, as permitted under Rule 152, (2) close contracts "under the rule", or (3) facilitate the borrowing and lending of money, (c) circulating sensational rumors or failing to report them, (d) using confidential information improperly, (e) quoting a nominal market, (f) refusing to testify, (g) betting.

Rule	
*4	Prohibits members from creating or inducing a false, misleading or artificial appearance of activity or artificially influencing the market price.
*5	Requires members to obtain permission before making transactions off the floor. (1)
*6	Requires members to place an identical bid or offer on the floor as that made off the floor. (1)
*7	Permits short sales of odd-lots to be made only "regular way" and on a "+" or "0 +" tick except for: (1) sales in stocks handled by a "specialist odd-lot dealer", and (2) sales for special and international arbitrage accounts.
*8	Prohibits members from: (1) assuming any stamp tax for their own account, (2) allowing another member to intervene by reopening a contract subject to a stock transfer tax, (3) making purchases of stamp taxes at other than authorized agencies.
*9	Requires that a plan for issuing "when, as and if issued" securities be on file before being admitted to dealings.
10	Requires the consent of the Chairman or President before a communication is read or a statement is made to the Exchange.
11	Levies a $250 fee for special Board meetings to consider matters not of general interest although the fee may be waived.
12	Requires a regular member after being elected to appear before the Chairman or President.
13	Permits members who are personally interested to examine Exchange records.
*14	Requires the posting of a proposed salaried market employee on the bulletin board for 6 days prior to Board consideration.
*15	Requires Board approval for an Exchange Governor, Officer, or employee to make or obtain a loan except where fully secured by marketable collateral or made or obtained by a Governor from his member organization.
*16	Prescribes rules for dealing in rights or warrants, including dates of expiration and types of contracts.
*18	Prescribes the procedure a company follows for filing an application to delist its security and when notice of reasons should be sent to stockholders.
*19	Describes the conditions a plan must meet before trading is allowed on a "when distributed" basis.
*20	States that the rules pertaining to "when issued" and "when, as and if issued" trading and contracts also apply to "when distributed" trading.
*21	Empowers the Chairman to appoint Floor Officials who, in turn, are to supervise activity on the floor.

(1) Amendments under consideration.

II. Floor Rules

Section 1—General Floor Rules

Rule	
*100	Limits hours of floor dealing to 10:00 A.M. to 3:30 P.M.
*101	Permits dealings in only those securities admitted on the Exchange by the Board.
*102	Prohibits dealing in privileges to receive or deliver securities or dividends.
*103	Prohibits each regular member on the floor from: (a) dealing in stocks in which he holds or has granted an option, (b) initiating transactions in a joint-account with nonmember unless approved by the Exchange except for domestic or foreign arbitrage, and permitted accounts of a specialist odd-lot dealer, (c) handling discretionary orders, except as specified.
104	Prohibits members from giving up the name of a nonmember.
105	Requires members to give up clearing agent's name.
106	Prohibits compelling a party to accept a substitute principal unless declared as part of bid or offer.
*107	Authorizes a Floor Official to approve the making of a short sale to equalize the price of a security traded on another exchange.
*108 and *110	Gives priority to orders originating off the floor over members' purchase orders made on the floor. Regulates the activities of floor traders.

Special Study Recommendations: Floor trading should be eliminated on the American Stock Exchange in stages by January 2, 1965, except for necessary transactions by specialists or odd-lot dealers in stocks in which they are registered, and error-offsetting transactions. (Recommendation 1, Ch. VI—F, p. 241.) The feasibility of floor traders acting as auxiliary specialists should be considered. (Recommendation 2, Ch. VI—F, pp. 242, 243.)

Special Study Comment: A number of reasons are cited for this recommendation with particular emphasis on the allegation that floor trading is a vestige of a former "private club" character of stock exchanges and that it accelerates price trends. The recommendation also applies to the N.Y.S.E. The Special Study acknowledges that floor traders frequently assist specialists in handling difficult openings and large blocks, and sometimes act as quasi-specialists. Recommendation 3 on page 242 states that floor trading on regional exchanges in dually listed stocks should be given separate consideration by the Commission.

Commission Comment: ". . . in light of the very serious and basic problems presented by the continuation of floor trading, as brought out by the Report of the Special Study and as evidenced by prior studies, and of the lengthy and apparently unsuccessful efforts to resolve them, the Commission agrees that a rule proposal abolishing floor trading on the New York and American Stock Exchanges should be developed, unless these exchanges demonstrate that its continuance

would be consistent with the public interest." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 3.)

Exchange Comment: The Special Study concedes that floor trading adds continuity, liquidity and depth to the market. The Exchange believes that the importance of these material benefits is under-estimated by the Special Study.

Floor Traders' participation in the market is limited by the rules and they have a responsibility to adhere to those rules. (Rule 108, for example, provides that the public will have priority in the execution of its buy orders over members who are on the floor.) In addition, floor traders are subject to close daily surveillance. Finally, their impact on price trends is open to question particularly in light of the restrictions of Rule 110.

The Special Study comment that floor trading on regional exchanges in dually listed stocks should be given separate consideration recognizes that markets may well derive benefit from proper floor trading practices.

As for the proposal that floor traders become auxiliary specialists: as a practical matter, it is difficult to imagine that floor traders would make themselves available as auxiliary specialists—bound by the restrictions and risks imposed on specialists, but with few of the benefits.

The Commission has indicated the Exchange will be given an opportunity to comment before it (the Commission) considers promulgating a rule. The Exchange is now conducting studies to determine the impact of floor trading on the markets for stocks listed on the A.S.E. If there is a need for amendments or additions to floor trading rules, that need should be demonstrated by up-to-date studies. The Special Study recommendation is extreme, was not based on a current review of floor trading on the A.S.E., and does not appear to be based on the kind of data required before a move to eliminate the business of a group of people is considered.

Rule	
*109	Denies the privilege of "stopping" stock for accounts in which a member has an interest.

Special Study Recommendation: The Special Study recommended that the A.S.E. prohibit "stops" at any price at which a specialist holds an unexecuted customer's order. (Recommendation 7(c), Ch. VI—D, p. 169.)

Special Study Comment: The Special Study feels that there is a basic unfairness to a customer who places his order with a specialist when the specialist grants a "stop" to someone else at the same price at which he holds the first order. If an order to sell that is stopped at the bid, for example, is successfully executed at a higher price, the bid on the book does not get an execution, and if the market turns away, the order may never be executed.

Exchange Comment: The recommendation and comment of the Special Study illustrate a problem inherent in a number of recommendations, i.e., the fact that disparate goals sought by the Special Study are not reconcilable. In this case the Special Study is concerned about the customer whose order is on the book. But elsewhere in the report the Special Study is equally concerned about maintaining price continuity with depth. In many instances, these goals are mutually exclusive. In fact, whenever a specialist performs his duty of maintaining a close market by injecting himself as a buyer or seller, a customer's order on the book is not executed. The practice of stopping stock is a useful mechanism to add price continuity and to minimize the effects of temporary disparity between supply and demand.

The Exchange allows a specialist to stop stock only where it aids him in helping make a market more fair and orderly and in minimizing a temporary disparity between supply and demand. The Exchange prohibits specialists from stopping stock where there is only a ⅛ point spread between the quoted market. Generally, a specialist may not stop stock in which there is a heavy volume. However, the stop is permitted and is a very valuable tool in preventing inactive stocks from varying substantially in price from one trade to another.

The Exchange is continually searching for mechanisms that enable specialists to maintain closer markets. Experience indicates that stopping stock frequently helps a specialist accomplish this, and the Exchange therefore doubts whether the adoption of this recommendation would be in the public interest.

Rule	
*111	Empowers the Board to suspend violators of floor trading rules.

Section 2—Units of Trading, Bids, Offers and Quotations

*120	Prescribes the units of trading for bonds, $1,000 in par value, and stocks, 100 shares, unless otherwise fixed.

Special Study Recommendation: A government-industry study should be undertaken to consider reducing the round-lot unit for all or some securities. Such a reduction would add to the depth of auction markets by bringing a portion of present odd-lot trading directly into the balance of available supply and demand. (Recommendation 2, Ch. VIII—B, p. 836.)

Special Study Comment: There is a direct relationship between the round-lot unit of trading and the depth of the market because odd-lot transactions are handled outside the regular auction market. A reduction in the round-lot trading unit would remove a substantial segment of present odd-lot trading from special handling and bring it into the flow of buy and sell orders constituting the depth of the market at any given time.

Although this suggestion has been brought up from time to time, it has generally been rejected because the mechanics of doing business would be greatly complicated. The Special Study says advances in technology eliminate this difficulty, but notes that it would be necessary in such an industry study to consider the ramifications of present commission rates and the odd-lot differential. (Ch. VIII—B, pp. 831, 832, 835.)

Commission Comment: "We agree, as suggested by [Recommendation 2], that a government-industry study of the feasibility and desirability of reducing the round-lot unit for all or some securities should be undertaken in the near future." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 6.)

Exchange Comment: Under A.S.E. Rule 120, the unit of trading in bonds is $1,000 and the unit of trading in stocks is 100 shares, unless otherwise specified. The fact is that the Exchange has fixed a unit of trading of 10 shares in 37 issues, 25 shares in 21 issues, 50 shares in 27 issues and 100 shares in 930 issues.

The considerations stressed in the Special Study with respect to the timing of odd-lot transactions and the depth of the market at any given moment are not entirely applicable in the case of the A.S.E., where odd-lot orders are executed automatically at the time of, and on the basis of, the last full-lot transaction.

The Exchange is in the best position to weigh pertinent factors and determine where a unit of trading less than 100 shares is appropriate. The Exchange considers the public distribution of shares, number of shareholders, the type of security, and price per share.

The cost of handling transactions should not be minimized. It is obviously more costly for a brokerage firm to process four transactions in units of 25 shares than one transaction in the unit of 100 shares.

The Special Study, in making its recommendation, has identified the basic considerations. The Exchange has also done so, in terms of the particular problems of its marketplace, and feels that the matter should remain within its discretion.

Rule	
*121	Deems all bids or offers made on the floor be in the unit of trading unless otherwise indicated.
*122	Deems bids or offers for more than one unit of trading be for the prescribed amount unless the bids or offers are executed to meet the conditions of an "all or none" bid or offer.
*123	Prescribes bidding and offering be frequent and generally known.
*124	Describes types of bids and offers, namely, "cash", "next day", "regular way", "sellers option", "when issued" and "all or none".
*125	Deems a bid or offer to be "regular way" unless otherwise stated.
*126	Prescribes precedence for bids and offers under varying situations.
*127	Prescribes the minimum fractional changes for dealing in securities.
*128	States that all bids and offers made in accordance with the rules of the Exchange constitute binding contracts.
*129	Prescribes that the price at which an order is executed is binding even though reported erroneously.
*130	Prohibits members from publicly offering to buy or sell securities on the Floor "on stop" above or below the market or "at the close".
*131	Describes when stop orders become market orders.
*132	Prescribes the basis upon which certain types of open orders are reduced on "ex-dividend" days.
*133	Prohibits transmitting names from the floor other than the name of a specialist acting on his own account and the name of the opposite party for processing the transaction.

Section 3—Members Acting as Brokers

*150	Prohibits a member from buying or selling securities for his own account while holding for a customer an unexecuted market or limit order, but does not apply to specialist odd-lot dealers, nor where the delivery is to be made on a day other than that specified in the unexecuted order.

Rule

*151 Requires that a member holding a customer's order to buy and a customer's order to sell attempts to execute each order above or below the minimum fraction of trading before crossing the order between customers, indicating "on order" when done.

*152 Prohibits members from taking or supplying stock to fill a customer's order except where an error has been made, or the customer receives a better price than on the open market; the broker is not to charge a commission.

*153 Provides that records of orders be preserved for twelve months.

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*154 Prohibits members from placing any orders with specialists except market or limited price orders.

Special Study Recommendation: The A.S.E. should continue the ban against specialists' accepting "not-held" orders. (Recommendation 7 (b), Ch. VI—D, p. 169.)

Exchange Comment: Rule 154 specifically meets the point of this recommendation.

Section 4—Members Acting as Specialists

*170 Requires a specialist to be registered with the Exchange, and have capital of $50,000 or a position of 10 trading units, whichever is greater.

Special Study Recommendation: Specialist capital requirements should be strengthened as necessary. (Recommendation 4, Ch. VI—D, p. 168.)

Special Study Comment: The Special Study noted that the capital requirements of the A.S.E. were increased in early 1962. (Ch. VI—D, p. 69, fn. 112.)

Exchange Comment: The Exchange believes that its specialist capital requirements, as increased in 1962, are adequate and realistic for the needs of the market. The Exchange is also prepared to restudy its requirements whenever necessary.

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*171 Permits a regular member to act as a temporary specialist.

*172 Places a temporary specialist in the same relationship to the book as the registered specialist.

*173 Prohibits the specialist from disclosing his book to anyone other than a Floor Official.

*174 Prohibits a specialist from making a transaction for his own account other than one which is reasonably necessary to permit him to maintain a fair and orderly market.

Special Study Recommendation: The portion of the Saperstein Interpretation restricting specialist dealings to those reasonably necessary to maintain a fair and orderly market should be

embodied in a rule under Section 11(b) of the Exchange Act. (Recommendation 2, Ch. VI—D, p. 168.)

Special Study Comment: The reason for suggesting a formal S.E.C. rule under Section 11(b) is that too much emphasis is given to a high level of participation. (Ch. VI—D, p. 163.)

Commission Comment: "... we agree that a Commission rule concerning the dealer functions of specialists should be considered which would define, on the one hand, responsibilities and on the other restrictions upon trading." (S.E.C. Special Study Release No. 3, July 23, 1963, p. 2)

Exchange Comment: Rule 174 of the A.S.E. already embodies that portion of the Saperstein Interpretation restricting specialists' dealings to those reasonably necessary to maintain a fair and orderly market. The Exchange feels this rule underscores the role that specialists are expected to fill on behalf of the investing public.

The A.S.E. considers each specialist's performance on its merits: whether it has added orderliness to the market, whether it has moderated temporary disparities in supply and demand, and what degree of participation was necessary to contribute liquidity and depth to the market in view of the particular stock and circumstances at the time. Proper (but not excessive) participation by specialists is encouraged.

The recommendation that a rule be adopted under Section 11(b) should be weighed in light of Special Study Recommendation 6, Chapter XII—I, to the effect that the S.E.C. should reduce direct participation in areas now adequately self-regulated.

Standards related to specialist performances can be made clearer and over a period of time additional tests can be developed as more sophisticated data processing equipment becomes available. The A.S.E. is, in fact, engaged in both these efforts at the moment. But it is doubtful that a proliferation of rules governing transactions on the floor would add to the orderly functioning of the market. On the contrary, an excessive number of rules could adversely affect the market mechanism. A far more promising approach lies in developing additional sound standards.

Rule	
*175	Prohibits a specialist in a security in which he is registered, from holding or granting an option, participating in a non-regular member joint account, acquiring or holding convertible securities or participating in a finder's fee.
*176	Requires a specialist in an inactive security to keep abreast of other markets.
*177	Requires a specialist to report to a Floor Official unusual activity, material information, options, or unusual transactions in a security in which he is registered.
*178	Requires a specialist to be responsible for any loss sustained due to his negligence in executing an order up to 11:00 a.m. the following business day.
179	Prescribes the procedure for handling orders in rights or warrants during the four business days preceding the final day for trading.
*180	Requires a specialist to keep a record of orders for twelve months.
*181	Requires members to submit written and signed cancellations.

Rule	
*182	Requires a specialist to deposit with the Exchange one share of each unlisted security in which he is registered.
183	Requires a specialist to pay a $200 annual registration fee.
184	Permits a specialist to employ clerks.
*185	Prohibits a specialist from adjusting the price of a transaction without approval.
*186	Prohibits a specialist from being an officer of any corporation in whose stock he is registered as a specialist, nominating anyone to the Board of Directors, soliciting any proxies or entering into a proxy contest.
187	Prohibits a specialist from trading off the floor for his own account any security in which he is registered, unless to offset a transaction made in error.
*188	Prohibits a specialist from trading for his own account in stocks traded at other sections of his post.
189	Prohibits a specialist from purchasing a security for a customer off the floor except to offset a transaction made in error.

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*190(a)	Prohibits a specialist from transacting business with the management of the company in whose security he is registered.
* (b)	Requires a specialist to file a report of any account he introduces to another firm.
* (c)	Requires a specialist to report any transactions made for his firm or a firm handling an account which he introduced in a security in which he is registered.

Special Study Recommendation: The N.Y.S.E. and A.S.E. should adopt rules prohibiting specialists from servicing the accounts of public customers or receiving commissions on such accounts "introduced by them at their firms". (Recommendation 7(f), Chapter VI—D, pp. 169-170.)

Special Study Comment: "Specialists and their firms should not be allowed to have their own retail customers . . ." (Ch. VI—D, p. 166.) The potential for discrimination and difficulties of surveillance are so great that N.Y.S.E. and A.S.E. specialist firms should not be permitted to service public customers or to introduce accounts to other firms. Separate treatment is appropriate with respect to specialists on regional exchanges. (Ch. VI—D, p. 157.)

Commission Comment: ". . . we agree that specialists should be prohibited from servicing public customers. We believe that the Commission and the exchanges should consider whether the association of a specialist with a firm having public customers calls for remedial action." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 3.)

Exchange Comment: The importance of public customers to specialists varies from firm to firm, depending upon the size of the firm, its historical business pattern and the inter-relationship of its specialist business and its over-all business.

The Special Study says there is no evidence of wide-spread abuses resulting from the fact that some specialists service customers who originate orders away from the trading floor. Yet it sug-

gests there is a potential for abuse. Thus the recommendation casts doubt on the integrity of member firms without specific evidence and suggests that established relationships between firms and customers should be disrupted because of the possibility of wrong-doing of some undefined nature in the future.

A major observation of the Special Study is that an effort should be made to improve the capital positions of specialist units. Yet the effect of this recommendation is to suggest that capital resources of specialists be diminished in many cases. If firms were forced to split into two or more organizations, the resulting firms would be smaller and weaker. If firms were forced to give up specializing (to concentrate on their public business) the Exchange would be weaker as an institution. As matters now stand, a specialist firm doing a public business has the full resources of paid in capital to back up the "book" as the need arises.

A critical goal of the American Stock Exchange is to attract capable people and added capital to the heart of the auction market—the specialist unit. If this recommendation were adopted, the Exchange could not interest firms now doing a public business in specializing. It might lose, as specialists, existing firms coupling their specialist functon with their other business. It would surely see a flight of capital and a reduction in manpower in the case of some firms now doing both a specialist and a public customer business. The comment of the Commission, quoted above, may indicate a recognition of this problem.

The Exchange's position is that any possible future abuses or conflicts should be identified and measures should be considered to preclude them from occurring. This is a complex matter which requires deeper consideration, and a more realistic approach, than that described in the Special Study.

Rule

***191** Requires a specialist to report to the Exchange before 10 A.M. of next day on all transactions made for his account (all dealer transactions) and the type of tick on which it occurred.

Special Study Recommendation: The A.S.E. should report to the S.E.C. on a weekly basis each specialist's purchases and sales as principal in each issue traded and such reports should be made public. (Recommendation 8, Ch. VI—D, p. 170.)

The A.S.E. should also, in conjunction with the S.E.C., develop new surveillance procedures using modern automation techniques. (Recommendation 11, Ch. VI—D, pp. 170, 171.)

Special Study Comment: Specialist dealer reports should be made public so as to give interested investors an indication of the degree of activity in each issue, exclusive of specialist participation. Also, reports that show specialists' income derived separately from brokerage and from dealer transactions should be prepared. In connection with surveillance, methods that permit reconstructing a specialist's book for a given period and new tests that relate a specialist's performance to price movements should be developed.

Commission Comment: "We agree with [Recommendation 8], calling for further reports by specialists and recommending that they be made public. . . . We also agree that additional surveillance techniques regarding specialist performance should be developed in accordance with the

recommendations contained in [Recommendation 11]". (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 3.)

Exchange Comment: The information contained in daily reports made to the Exchange under Rule 191 will be augmented in several months with other market surveillance data planned as a result of the Exchange's automation program. In addition, for the past year, the Exchange has been studying surveillance techniques and has revised its procedures so that a specialist's purchases and sales can now be related to the price movement in each stock. Also, tests that measure the impact on the market of a specialist's stabilizing and destabilizing transactions and the degree to which a specialist provides depth on a day of significantly rising or falling prices are being explored. In this connection, the Exchange also plans to undertake continuity and quotations studies.

Reports of specialists' positions to the public would be susceptible to serious misinterpretation and would likely generate unwarranted and uninformed speculation. The Exchange is not in favor of such disclosure.

Section 5—Members Acting as Odd-Lot Dealers

Rule	
*200	Requires odd-lot dealer to be registered with the Exchange.
*201	Permits a member to act temporarily for a registered odd-lot dealer.
*202	Requires the temporary odd-lot dealer to stand in the same relationship as that of the registered odd-lot dealer.
*203	Prohibits odd-lot dealers from participating in a joint account with non-registered odd-lot dealers.

Section 6—Floor Wires

*220	Requires Exchange approval of the communication method used between a member on the floor and his office.
221	Permits installing additional wires to members not on the floor if certain conditions are met.
*222	Empowers the Exchange to revoke a floor wire privilege at any time.

III. Office Rules

Section 1—Partnerships

*300	Requires Exchange approval of partnership agreements and financial statements of member firms.
*301	Requires approval of amendments to partnership agreements.
*302	Conditions approval on provision requiring member firm to keep true and complete books of accounts and records.
303	Requires that duplicates of agreements be furnished each partner.

Section 2—Corporations

Rule	
*310	Requires members who intend to organize or become a stockholder of a member corporation to notify A.S.E. Requires approval of Charter, By-Laws and related documents of regular and associate member corporations.
*311	Requires that notice of material change in personnel or structure of regular and associate member corporation be filed with A.S.E.
*312	Requires Exchange approval, in respect of regular member corporations, as follows: (a) officers and directors, (b) amounts of voting or non-voting stock that can be owned by officers and directors, (c) number of stockholders, (d) any reduction of capital or amendment to Charter or By-Laws, (e) any issuance or transfer of stock, (f) any issuance of bonds, notes, etc., (g) all agreements relating to management or the issuance or transfer of securities.
*313	(a) Requires that directors, officers and employees of regular member corporations maintain 40% interest represented by all the voting stock. (The established policy of the Exchange requires a similar interest to be held by general partners of regular member firms.) (b) Prohibits ownership of voting stock of regular member corporations by non-officers, directors or employees and limits them to 45% profit participation.

Section 3—Member Offices

*320	Requires Exchange approval of all branch offices.
*321	Imposes responsibility for conduct of branch office on members.

Special Study Recommendation: Broker-dealers should adopt supervisory procedures over the selling activities of their personnel, especially in branch offices. Suggested procedures include (1) designating one home office executive responsible for internal supervision, (2) emphasizing the branch manager's supervisory role while de-emphasizing his selling activities and (3) tightening home office control procedures of large firms by using electronic data processing techniques. (Recommendation 1, Ch. III—B, p. 328.)

Special Study Comment: Among the more common improper selling practices are over-trading of a customer's account, misrepresentations and recommendation of unsuitable securities. The responsibility for adequate supervision to curb these practices must be borne by broker-dealers and the key to proper supervision is the branch manager. (Ch. III—B, pp. 290, 296, 325.)

Centralized (home office) controls, consisting of senior supervisory personnel, an internal audit system and electronic data processing equipment, form a second keystone of internal supervision. (Ch. III—B, p. 325.)

Commission Comment: "With the exception of the major exchanges, significant standards of character, competence, and minimum capital have not been generally imposed. Nor has attention been sufficiently directed to the unique problems of supervisors, such as branch managers, and research analysts."

The Commission noted that even where high standards have been set, serious lapses have occurred. Sufficient powers presently exist in the self-regulatory institutions to make legislation unnecessary. (Transmittal Letter, April 3, 1963, Part I, pp. V, VI.)

Exchange Comment: The Exchange agrees with the Special Study that the responsibility for strengthening internal supervision should rest with the broker-dealer. Rules 320 and 321 reinforce this concept as does the Constitution (Article IV, Section 2 (i) (j)), although the Exchange reserves the right to disapprove any branch office where circumstances warrant such action. (Constitution, Section 2 (i) and Rule 320.)

The Exchange and other industry groups have begun discussions with the Commission to determine whether any further steps are appropriate in response to this recommendation.

Rule	
*322	Requires that certificate of membership be displayed in customers' offices.
*323	Requires members to maintain current copy of A.S.E. Guide.
	Section 3A—Fidelity Bonds
*330	Requires member organizations doing a public business to carry fidelity bonds on general partners, officers and employees.
	Section 4—Member Employees
*340	Requires registered representatives to devote entire time to the business of the member but may be an employee or officer or director of another firm or corporation or engage in other business with Exchange approval.
*341	Forbids nominal employment of any person because of business obtained by such person.

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*342(a)	Permits member organizations to compensate branch office managers and registered representatives on salary or commission basis or both.
*342(b)	Limits registered representative's compensation.
*342(c)	Permits branch manager to share in profits of his branch office.
*342(d)	Permits bonus distributions to employees of member organizations with approval of A.S.E.

Special Study Recommendation: The Exchange should adopt rules and standards with regard to compensating salesmen which would eliminate or reduce more extreme forms of pressure or bias in selling. (Recommendation 6, Ch. III—B, p. 329.)

Special Study Comment: Certain aspects of the widespread securities industry practice of compensating salesmen in proportion to the volume of business produced tend to introduce undue pressures and biases into the selling process.

Commission Comment: Improvements that relate to ". . . modes of compensating salesmen . . . will require continuous development, achieved in large part through discussion with the industry, through action of the self-regulatory agencies, and in some particulars through the exercise of rule-making power." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 4.)

Exchange Comment: Related provisions include Article IV, Section 2(j) of the Constitution empowering the Exchange to disapprove the remuneration of any employee of a member organization.

With Rule 342, there is adequate authority to govern undesirable forms of compensation. In considering the desirability of additional rules and standards regulating compensation, the delicate balance between the preservation of initiative through the profit motive and undue pressures should be kept in mind. In general, the Exchange feels that member organizations should not be unduly restricted in determining the compensation arrangements best suited to their particular types of business, the competitive conditions under which they operate, and related factors. Nevertheless the Exchange recognizes that its members should adequately supervise selling practices, particularly those where the profit motive of the salesman might result in unwarranted recommendations (churning), and to this end has adopted Rule 411 discussed below.

Rule	
*344	Prohibits employment of the press for the purpose of obtaining advance confidential information.
*345	Prohibits members from giving gratuities to employees of financial concerns without consent of employer and filing written notice of consent with the Exchange.
*346	Prohibits gratuities to employees of A.S.E. without approval of President.

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*347	Requires approval of registered representative.

Special Study Recommendations: (1) A system of licensing and registering individual salesmen, supervisors and other categories of personnel, without limiting the responsibility of firms for the personnel they employ or the right of firms to select their own employees, should be established. (Recommendation 4, Ch. II—F, p. 160.) (2) The self-regulatory agencies should establish clear standards and stronger surveillance and enforcement procedures over their member firms. There should be frequent branch office visits, including interviews of salesmen and customers. (Recommendation 2, Ch. III—B, p. 328.)

Special Study Comment: Regulations should cover individuals rather than firms in certain areas. Present statutory registration methods do not cover individuals, while the self-regulatory concept of "registered representatives" is not fully effective. The Special Study finds . . . "the adequacy of the substantive rules which delineate legal and ethical standards of selling in the industry are not always matched either by the techniques available to detect violations or the

enforcement action applied after detection." (Ch. II—B, p. 326.) In general, the rules of the N.Y.S.E. (and the A.S.E.) are adequate to cover the types of practices disclosed, but the methods of detection should be strengthened. (Ch. III—B, p. 327.)

Commission Comment: ". . . improvements . . . in surveillance and enforcement procedures . . . will require continuous development, achieved in large part through discussion with the industry, through action of the self-regulatory agencies, and in some particulars through the exercise of rule-making power." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 4.)

Exchange Comment: The provisions of Article IV, Section 2(j) of the Constitution and Rule 347 in conjunction with the provisions of Rule 342 (a) and (c) relating to the compensation of salesmen cover the objectives underlying these Special Study licensing recommendations. The information called for by the Special Study is currently obtained by the Exchange from its member organizations whenever they employ salesmen or persons to be trained as salesmen. In addition, the Exchange has the residual power under this Section to terminate the employment of any employee of a member.

A member organization must be approved as such by the Exchange. Each partner or stockholder also must be approved. Each person who is to sell securities must be qualified and registered. An extension of this elaborate system to other personnel could undermine the responsibility management must assume for its own people and operations. Self-regulation by industry organizations finds its essential strength in the assumption of responsibility by the proprietor of each economic unit. Over-paternalism by the A.S.E. could undermine the initiative for effective self-control within member organizations.

The Special Study's surveillance recommendations focus on an important area of Exchange activities. Major steps have been taken by the Exchange during the past year to increase the scope of its market surveillance, investigation and examination work and these efforts are described earlier in this statement. The Exchange is also considering further steps that may be possible. The Constitution of the Exchange (Article IV, Section 2(j)) empowers the Exchange to terminate or disapprove the employment of any employee of a member firm. The Exchange believes that this power, the program it has outlined and the authority provided by Rule 347, afford the proper basis for protection of the public.

Rule

Section 5—Joint Accounts

*360	Requires approval of joint accounts in which members participate.
*361	Requires filing of reports required by Rule 360 prior to effecting any transactions.
*362	Requires monthly report of substantial joint account transactions in which a member has an interest.
*363	Requires weekly reports to A.S.E. of substantial joint accounts known to member.

Rule	
*365	Prohibits participation by member firm or corporation in profits or losses of specialist joint account unless a firm principal is registered and active at the post in such joint account.

Section 6—Collection of Commissions and Fees

380	Imposes collection of commission on settling member when nonmember order executed by one member is given up to another member.
381	Imposes collection of commission on clearing firm where clearing firm given up on orders received from a member.
382	Requires member to charge an additional sum not less than minimum commission when member effects transaction in security traded on A.S.E. in market outside the U.S. or Canada.
383	Similar to Rule 382 when a member not only effects but clears such a transaction.
384	Requires commission charge when securities are received or delivered on privilege.
385	Requires mutual agreement clearing charge on bonds for a member be based on a fixed rate per $1,000 of bonds.
*386	Requires members to charge their customary commissions on commodity business for customers dealing in securities on the Exchange.
387	Forbids execution of "bunched" orders without charging the required commission.
388	Prohibits over-the-counter transactions by members acting as principals in securities dealt in on the Exchange and reverse transactions on the Exchange at or about the same time when the difference between purchase and sale prices is less than the commission charged on such transactions on the Exchange.
389	Requires clearance of commissions to be made through A.S.E. Clearing Corporation when principal given up unless otherwise agreed.
390	Prohibits members from assuming customers' losses without A.S.E. consent or unless contract made by mistake.
391	Prohibits granting of special advantages to customers.
*392	Prohibits interest allowances on short sales in excess of the loan market rates for the stock borrowed or used.
*393	Requires payment of S.E.C. registration fee.
394	Requires members to charge prescribed nonmember commission upon receipt or delivery of nonmember securities against payment.
395	Provides for commission rates on rights and warrants.

Section 7—Conduct of Accounts

Rule	
*410	Prohibits carrying of customers' accounts by individual members.
*411	Imposes duty on every member and member organization to know and approve customers. ("Know Your Customer" Rule.)

Special Study Recommendation: The self-regulatory bodies should make statements of policy emphasizing the concept of suitability of particular securities for particular customers. Such statements should cover (1) guidelines as to securities which are clearly unsuitable in specified circumstances, (2) practices incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to other than known customers, and (3) approved and disapproved practices in the handling of discretionary accounts. (Recommendation 4, Ch. III—B, p. 329.)

Special Study Comment: The Special Study took note of the detailed Rules of the A.S.E., including Rule 411, governing selling practices. (Ch. III—B, p. 321.)

Commission Comment: "... improvements ... in existing concepts of suitability ... will require continuous development, achieved in large part through discussion with the industry, through action of the self-regulatory agencies, and in some particulars through the exercise of rule-making power." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 4.)

Exchange Comment: Rule 411 requires due diligence to learn the essential facts about every customer and every order, placing responsibility on both salesmen and managers. It further requires every member, either personally or through a general partner of his firm or an officer of his corporation, to supervise diligently all accounts handled by an employee. These requirements are compatible with clauses (2) and (3) of the statement of policy recommended. Rule 421 requires partners' supervision of all discretionary orders entered by employees. Rule 422 prohibits excessive transactions in discretionary accounts.

The "know your customer" rule of the A.S.E. obliges registered representatives and managers to know the essential facts concerning customers and financial arrangements. The "suitability" approach implies that the registered representative should substitute his judgment for that of the person who is buying or selling. This is an unnatural arrangement inconsistent with the concept that investors should investigate the facts and tailor their decisions to their own goals and circumstances. Moreover, the question of suitability often cannot be judged until the success of the investment is known. It may not be an oversimplification to say that an investment is "suitable" if the value of the security increases after it is purchased, and "unsuitable" if the opposite happens.

The A.S.E. feels, in general, that the salesman should know his customer and pertinent facts concerning the account and be in a position to call attention to investment alternatives. The final judgment as to suitability is properly lodged with the customer himself.

Rule	
*412	Requires that member not pledge or lend more of customer's securities than is fair and reasonable in view of the indebtedness of the customer to the firm.
*413	Prohibits delivery of customer's securities for firms' account without a specific, separate written agreement.

Special Study Recommendation: The S.E.C. should be empowered to adopt rules requiring that there be a "reasonable relationship" between the amount of a customer's securities that can be hypothecated or lent and the amount of the customer's indebtedness; and requiring further that broker-dealers obtain the specific, prior written consent of a customer before borrowing or lending his excess margin or fully paid securities. (Recommendation 3, Ch. III—D, p. 415.)

Special Study Comment: Rule 412 requires that a "reasonable relationship" be maintained between the amount of a customer's debit balance and the amount for which his securities may be pledged or lent.

The Special Study said: "Appropriate action by other exchanges and the N.A.S.D. could accomplish the desired result, but to insure both action and uniformity of standards, a Commission rule, perhaps one exempting broker-dealers subject to an equally stringent self-regulatory rule, is indicated." (Ch. III—D, pp. 406, 407.)

Commission Comment: The Commission accepted the "underlying principle" of the recommendation but indicated that it wished to hold a conclusion in abeyance and bring it to Congress at a later date. (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: Rule 412 is designed to protect investors by limiting the amount of a customer's securities that may be borrowed or lent by A.S.E. members. Rule 413 protects investors by requiring that a customer gives his consent before his securities may be used by a firm for deliveries for its own account. Prior written consent of a customer before borrowing or lending his securities, is obtained as a matter of customary practice among A.S.E. members and is checked in the course of inspections by Exchange examiners.

The adoption by the S.E.C. of generally applicable rules governing use of customer's securities might be advisable to assure that broker-dealers meet uniform, minimum standards. If such rules are adopted, there should be an exemption for members of self-regulatory organizations having rules of at least equal stringency. Such an exemption would accord with the principle that maximum scope should be given to self-regulation wherever it can meet the regulatory need. A similar exemption, under the Commission's net capital rule, reflects recognition of the Exchange's effective enforcement of its own net capital requirements.

Rule	
*414	Prohibits installment purchases if the carrying charge is unreasonable.
*415	Prohibits member companies from carrying an account for a general partner or stockholder of another member company without the prior consent of another general partner or voting stockholder of that company.

Rule	
*416	Requires members to obtain employer approval and send duplicate reports and monthly statements to the employer whenever accounts are carried for employees of the Exchange or a member.
*417	Prohibits members from carrying margin accounts of employees of financial concerns without the written consent of the employer.
*418	Prohibits members from associating with bucket shops.
*419	Requires members to mail confirmation and statements to customers unless otherwise directed by the customer in writing.

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*420	Requires members to mail confirmations and statements to customers even though the customer has given a power of attorney.
*421	Prohibits members' employees from handling discretionary accounts without prior written consent of the customer and requires partners supervision of all discretionary orders. (See Exchange Comment following Rule 411.)
*422	Prohibits excessive transactions in discretionary accounts.

Special Study Recommendation: Statements of policy should be made with respect to approved and disapproved practices in handling of discretionary accounts. (Part of Recommendation 4, Ch. III—B, p. 329.)

Special Study Comment: Customers complain of over-trading or churning of accounts where no discretionary authority has been given. Even though there are certain rules prohibiting discretionary transactions without express customer approval, abuses still prevail. (Ch. III—B, p. 271.)

Exchange Comment: Rule 421 prohibiting registered representatives from handling discretionary accounts without prior written consent of the customer, and Rule 422 prohibiting excessive transactions in such accounts, make Exchange policy clear. The Special Study recommendation that statements be made illustrating approved or disapproved practices has merit and the A.S.E. will cooperate with other industry groups and the S.E.C.

Section 8—Reports of Financial Condition

*440	Requires members not doing customer business to file a certificate to that effect with the Exchange.
*441	Requires members doing customer business to file financial reports with the Exchange.
*442	Requires members to disclose their financial condition to customers on request.
*443	Requires members to file with the Exchange an audit of their accounts, at least once a year, prepared by an independent public accountant.
*444	Requires monthly reports of member indebtedness and loans.
*445	Requires weekly statements of members obligations and net positions with respect to security underwritings.

Rule	
*446	Prescribes minimum net capital of $50,000 for member organizations doing a public business and clearing members, $25,000 for member organizations not doing a public business and $25,000 for individual members who employ one or more registered representatives.

Special Study Recommendation: Every broker-dealer should have a minimum net capital requirement keyed to its type and size. (Recommendation 11, Ch. II—F, p. 161.)

Special Study Comment: "The American (Stock Exchange has) also shown commendable concern for member firms' financial responsibility. . . . All clearing members of the American Stock Exchange and all other members having public customers must have net capital of $50,000. Other members must have a net capital of $25,000." (Ch. II—B, p. 88.)

Commission Comment: With respect to Recommendation 11, ". . . relating to net capital requirements, the Commission will also provide in the legislative proposals that the self-regulatory organizations may have the same power with respect to financial reponsibility as they would have with respect to character and competence." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 4.)

Exchange Comment: Rule 446 provides for a minimum net capital keyed to a firm's type. Related Rules 466 and 467 require net capital equal to at least 1/20th of aggregate indebtedness and are more stringent in several respects than Rule 15c3-1 under the Exchange Act. The suggestion by the Study that capital requirements also be geared to the size of a firm is met by the aggregate indebtedness test of Rules 466 and 467. In practice, member firms seldom approach the limit of the 20 to 1 ratio of aggregate indebtedness to net capital and normally have substantial excess capital.

The Exchange believes Rule 446 and its related capital rules are designed to provide adequate safeguards for investors. The Exchange's concern for the financial responsibility of its members, especially those transacting business with the public, is well established.

Section 9—Margin Rules

Rule	
*460	Prohibits members from extending credit to a customer who is inadequately margined.
*461	Authorizes the Exchange to establish minimum margin requirements.
*462	Prescribes the minimum margin requirements in extended detail.
*464	Requires members to keep records of margin calls and receipts of margin for twelve months and prohibits a member from letting customers furnish margin by liquidation.

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*466-467	These rules, together with Rule 446, constitute the capital requirements of the Exchange for member organizations doing business with the public. Among other things, they set a maximum ratio of indebtedness to net capital, prescribe the

method for computing aggregate indebtedness and net capital, and require that certain percentages be deducted from the value of securities held in inventory for the purposes of determining net capital. (These deductions are known colloquially as "haircuts".)

Special Study Recommendation: Consideration should be given to the feasibility of providing greater flexibility in the so-called "haircut" provisions of the net capital ratio rules and in their administration, in order to take account of different functions, market circumstances and needs. (Recommendation 4, Ch. III—D, p. 415.)

Special Study Comment: The Study notes that there are certain respects in which the Exchange's net capital ratio rules are stricter than the Commission's rule. The Exchange's rule prescribes greater "haircuts" with respect to certain kinds of securities. Furthermore, the Exchange has greater flexibility than the Commission in that it is empowered to impose larger "haircuts" on securities than are prescribed by its rules if this for any reason is deemed desirable. (Ch. III—D, p. 408.)

Commission Comment: The Commission accepted the "underlying principle" of the recommendation but stated that it ". . . calls for further study." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: The Exchange believes that its net capital rules are designed to give adequate protection to investors and that they provide sufficient flexibility to accomplish the end sought by the Special Study. The Exchange, through its reporting requirements and periodic inspection system, maintains surveillance over the capital position of member firms and will move to discourage over-accumulation of inventory where this appears desirable. Its efforts appear to have been successful since there has been only one failure of a member firm since 1938.

Section 10—Advertising

Rule	
*480	Prohibits members from publishing advertisements other than those of a strictly legitimate business character.
*481	Requires members' advertisements to be in a general form approved by the Exchange or receive Exchange approval prior to publication.
*482	Prohibits members from advertising in quotation sheets having a strictly professional clientele with respect to common stock, warrants and ADR's traded on the Exchange.
*483	Defines market letters and requires that they be approved in writing by a partner of a member firm and be retained for three years.
*484	Prohibits any reference in any advertisement to any application, pending or proposed, to list a security on the Exchange except for an advertisement approved by the Exchange.

Special Study Recommendations: The self-regulatory agencies should direct more positive and effective attention to specific practices relating to investment advice, whether expressed in market letters, advertisements or otherwise. (Recommendations 2 and 3, Ch. III—C, pp. 386, 387.)

Special Study Comment: Market letter surveillance programs should be directed to greater responsibility and restraint in the use and contents of such letters.

Commission Comment: "[Recommendation 2] . . . in our opinion can be handled by rule. [Recommendation 2], relating to the content of market letters and investment advisory material, would require disclosures of sources of information, research techniques, existing positions in stocks recommended, persons responsible for the preparation of market letters, and other matters." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: Rule 483 places the responsibility for review of market letters on a partner or officer of a member firm or corporation. Rule 481 requires Exchange approval of every member advertisement not in a generally approved form.

The Exchange recognizes the desirability of a program related to investment advice practices and designed to provide more effective surveillance of market letters published by members. It is presently engaged in a review of its related rules and development of such a program.

Section 11—Wires and Other Means of Communication

Rule	
*500	Requires Exchange approval of wire connections with nonmembers.
*501	Requires registration with the Exchange of all means of communication approved under Rule 500.
*502	Authorizes the Exchange to discontinue any means of communication and requires a member to give prompt notice of discontinuance to the Exchange.
*503	Requires Exchange approval of wire systems used between member and nonmember offices.
*504	Requires wire operators to be registered with and approved by the Exchange.
*505	Requires Exchange approval for the use of a wireless system between two or more offices of a member and authorizes the Exchange to discontinue same.
*506	Prohibits members from broadcasting quotations, or making use of radio broadcasts for any other business purpose unless approved by the Exchange.
507	Prohibits payments by a member of wire and other expenses of a nonmember, except with Exchange approval.

Section 12—Reports

*520	Requires each member to report all options or selling agreements in which he has an interest relating to securities traded on the Exchange and permits it to disapprove same.
*521	Requires each member to report any disciplinary action taken by regulating body against him or his associates.

Section 13—Secondary Distributions

Rule	
*550	Requires Exchange approval of members' participation in an off-board secondary distribution of stocks dealt in on the Exchange.
*552	Prohibits delivery of securities in excess of subscription offered.

Section 14—Special Offerings and Special Bids

*560	Authorizes the A.S.E. to permit a Special Offering or a Special Bid to be made through Exchange facilities under numerous prescribed conditions and limitations.

Section 15—Exchange Distributions and Exchange Acquisitions

*570	Authorizes the A.S.E. to permit Exchange distributions and acquisitions.

Section 16—Proxies

*575	Prohibits each member organization from giving a proxy except as required or permitted under Exchange Rule 577 unless it is the beneficial owner.
*576	Requires members to transmit proxy material to beneficial owners upon assurance of reimbursement for out-of-pocket expenses.
*577	Specifies conditions under which a member organization may give a proxy for stock registered in its name.
*578	Requires that all proxies given by member organizations state the actual number of shares.
*579	Requires transfer of certificates into the name of a member organization upon request of Exchange for purpose of proxy solicitation.
*580	Makes individual members and nominees subject to A.S.E. proxy rules.
*581	Requires member organizations to transmit interim reports and materials to beneficial owners upon assurance of out-of-pocket reimbursement.

IV. Contract Rules

Section 1—General Rules on Securities Contracts

Rule	
700	Requires nonmembers of A.S.E. Clearing Corporation to clear through clearing member.
701	Governs maturity of contracts falling due on holidays.

Section 2—Exchange of Tickets and Comparisons

*720	Requires each clearing member to maintain adequate facilities for comparison of transactions; requires every member to report each floor transaction made by him and to have records available at his office.
*721	States method for comparison of transactions which are to be cleared through A.S.E. Clearing Corporation.

Rule	
*722	States method for comparison of transactions which are to be cleared through A.S.E. Clearing Corporation.
*723	Requires that transactions which were to be cleared through A.S.E. Clearing Corporation but have been excluded, be promptly compared as per Rule 721.
*724	Permits closing of contracts following failure to effect comparison.
*725	Provides that original party to transaction may give up names of other members who shall have the same duty of comparison as the original party. This does not constitute a substitution of principals except in the case of transactions in securities "when, as and if issued."
*726	Provides that comparison or failure to compare shall not have the effect of creating or cancelling a contract or changing its terms; provides that any loss resulting from such failure may entitle a member to bring a claim under the Arbitration Procedure of the Exchange.
*727	Requires approved form of written contracts for "when issued" and other special contracts not cleared through A.S.E. Clearing Corporation.
*728	Requires members receiving names given up on transactions to record such names.
	Section 3—Delivery of Securities
*749	Permits Board of Governors to extend or postpone the time for the performance of Exchange contracts when such actions appear called for by public interest or just and equitable principles of trade.
750	Establishes 12:00 noon as delivery time for securities.
751	Requires half hour delivery on cash transactions.
*752	Permits closing of contracts for securities due on any particular day which are not delivered within time specified in Rules 750, 751 or 759.
*753	Provides for payment for securities against delivery. Special rule where delivery is made by transfer.
*754	Requires a buyer to accept delivery of less than amount contracted for in specified lots and permits buy-in of remainder.
755	Requires that delivery of securities subject to tax be accompanied by appropriately stamped sales ticket.
756	Prohibits deduction from purchase price of damages for non-delivery, except by consent.
757	Makes orders of A.S.E. Clearing Corporation for receipt or delivery of securities binding on members.
758	Permits buyer or seller to confirm "fail to deliver" on overdue contract.
*759	Sets forth rule for delivery on "when, as and if issued" prior to final settlement date.
*760	Sets forth rule for settlement of contracts in securities exchangeable for other securities.

Section 4—Closing Contracts

Rule	
*780	Provides that when a disagreement arises concerning a securities transaction, money differences shall be established by purchase or sale or mutual agreement.
*781	Provides for the closing of contracts with a member suspended for insolvency.
*782	Provides for closing a contract where contract has not been compared as required by Rules 720-728.
*783	Permits contracts in securities which have not been fulfilled to be closed by a designated Exchange employee and provides for delivery of notice of closing.
*785	Requires members who are notified that a contract is to be closed to re-transmit notice thereof to any other members from whom securities involved are due.
786	Requires notice of intention to close for less than the full amount be not less than unit of trading.
*787	Imposes liability on each succeeding party in interest where contracts have been closed as provided in Rule 785.
*788	Provides notice be given by members to other members for whose account contracts have been closed and to succeeding parties in interest and for immediate statements of any resulting money differences.
789	Sets forth conditions under which member giving notice of intention to close contract for non-delivery must accept securities due on contract.
790	Sets forth method for closing contracts caused by non-delivery.
*791	Sets forth general rules for "buying-in" of securities.
*792	Governs "buy-in" of security where transfer office is not in New York and tender is made of security which is not a good delivery.
*793	Prohibits odd-lot "buy-ins" where defaulting party has larger units.
*794	Governs "buy-ins" on securities located out of town.
*795	Prohibits "buy-ins" for four days where satisfactory evidence is submitted that securities are in transfer with certain exceptions.
*796	Governs "buy-ins" in securities not dealt in on the Exchange.

Special Study Recommendation: The self-regulatory organizations and the S.E.C. should consider a requirement for mandatory buy-ins for various types of markets or categories of securities. (Recommendation 2, Ch. III—E, p. 428.)

Special Study Comment: The Special Study feels that a mandatory buy-in procedure might encourage defaulting broker-dealers to "clean up" old outstanding items. (Ch. III—E, p. 421.) "A mandatory buy-in procedure would not solve the other problems surrounding buy-ins such as controversies over whether a contract existed, whether the buy-in was properly effected and whether a market existed in which a given security could be bought in at a fair price." (Ch. III—E, p. 422.)

Commission Comment: "We agree with the four conclusions and recommendations [in Chapter III—E] which are addressed in large part to the industry and self-regulatory institutions. We shall lend our support in seeing that they are carefully considered." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: Generally, buy-ins of securities traded on the A.S.E. have not been a problem for Exchange members. The ten A.S.E. buy-in rules are designed to provide a workable, consistent approach towards dealing with undelivered securities between member firms. In addition to Rule 791, Rules 752, 754, 780, 787, 792 through 796 cover, among other things, such matters as partial buy-ins, settling money differences, imposing liability and handling buy-ins where the transfer office is outside New York. It should be noted that where a particular A.S.E. security has been in short supply, appropriate arrangements have almost invariably been made. A mandatory buy-in procedure appears unnecessary and could work a hardship on the public.

Section 5—Marking to the Market and Mutual Deposits

Rule

***810** Permits a party to a contract who becomes partially unsecured by a change in market value to demand the difference between the contract and market price (i.e., "marking to market").

Special Study Recommendation: Rules should be adopted permitting marking to the market on more contracts than now permitted. (Recommendation 1, Ch. III—E, p. 428.)

Special Study Comment: The Special Study cites the experience of the Pacific Coast Stock Exchange which adopted a mandatory marking to the market system with respect to fails which develop in its clearance operation. "The system, which makes use of modern data processing equipment, does not appear to have caused undue difficulty to members of the exchange [P.C.S.E.] and consideration might well be given to its adoption by other clearance operations." (Ch. III—E, p. 423.)

Commission Comment: Same as set forth above.

Exchange Comment: The Exchange has considered this recommendation, but certain technical and operating questions warrant further study.

Since fails are not a significant problem with respect to securities traded on the A.S.E., a mandatory marking to the market would not appear to be necessary at this time. However, there are several substantive rules which cover in some detail the marking to the market procedure. Specific A.S.E. Clearing Corporation requirements, for example, expand upon Rule 810 stated above, as well as Rule 811 (permitting either party to a transaction to require marking to the market) and Rule 812 (permitting marking to the market in case of contracts for borrowing and lending securities).

***811** Permits either party to require marking to market or mutual cash deposits in case of all Exchange contracts not governed by Rule 810.

***812** Permits marking to the market in case of contracts for borrowing and lending securities.

***813** Permits holder of due bill to require full deposit with A.S.E. Clearing Corporation if it agrees. If not, holder may require deposit in a Trust Company. If depositor

Rule

with A.S.E. Clearing Corporation is not a clearing member, deposit should be made for him by a clearing member.

814 Sets forth hours for demand on marking to the market due bills and mutual cash deposits.

*815 Makes failure of a party to a contract or holder or maker of due bill to make deposits in accordance with Rules 810-817 a default.

816 Requires, unless otherwise agreed, that members holding contracts for securities "when, as and if issued" participate in any intermediate clearances.

817 Releases mutual deposit between original parties of member participates in a special intermediate clearance on "when, as and if issued" securities.

Section 6—Dividends and Interest

*830 Sets forth procedure for establishment and announcement of ex-dividend and ex-rights dates.

*831 Entitles buyer, unless otherwise agreed, to dividends and rights, except voting power, of securities selling ex-dividend or ex-rights during pendency of contract.

*832 Permits 1% delivery charge on dividend or right transfer pertaining to securities holder has failed to transfer, but not when they accrue on securities deliverable on a contract.

Section 7—Reclamation

*850 Provides that reclamation for irregularity in a security be made within ten days of date of delivery when it affects only its currency in the market.

Section 8—Money and Security Loans

*860 Prohibits members from lending money for account of others or from receiving or paying interest on deposits unless they are qualified under Federal law to act as a banker.

861 Requires agreements for loan of cleared securities made by 4:30 p.m. on any business day be called, and delivery and payment of amount involved be made through A.S.E. Clearing Corporation, unless parties otherwise agreed; loans of cleared securities and re-delivery and re-payment likewise shall be made through the Corporation, unless otherwise agreed.

862 Governs time within which notice for return of loans of money and securities shall be made.

863 Requires payment of any agreed interest or premium on securities borrowed or loaned regardless of delivery.

*864 Makes money or security loan premium applicable only to day for which the loan is made.

*865 Prohibits payment of interest without actually making loan as contrasted.

*866 Provides for date of maturity of loans of money and securities.

*867 Entitles lender to sell securities pledged for loan if unpaid by 2:15 p.m. on due date.

Related Recommendations of Interest to Exchange

A number of recommendations made by the Special Study of the Securities and Exchange Commission do not relate to specific Exchange rules, but do concern the Exchange. In some cases it has been recommended that the Exchange adopt additional rules or procedures. These recommendations, with related comments of the Exchange, follow in the order in which they appear in the Special Study.

Bases for Disqualification

Special Study Recommendation: The bases for disqualification for N.A.S.D. membership should be broadened to include conviction within ten years for crimes involving theft, fraud or embezzlement or arising out of the conduct of business as a broker or dealer as well as the statutory bars set forth in Section 15(b) of the Exchange Act. (Recommendation 2, Ch. II-F, p. 159.)

Special Study Comment: In establishing minimum standards, the various lists of so-called statutory disqualifications, which now apply only to misbehavior relating to securities, should be expanded and made uniformly applicable to all categories, principals and employees. (Ch. II-F, p. 152.)

Commission Comment: This recommendation is reflected in H.R. 6789, Section 6(b).

Exchange Comment: The Exchange supports H.R. 6789. Section 6(b) of the Bill would amend Section 15(b) of the Exchange Act in a manner consistent with this recommendation.

The Board of Governors of the Exchange may, under Article V, Section 4(f) of the Constitution, expel any member or allied member who fails to disclose on his application that he has been engaged in fraudulent or dishonest acts prior to application for membership.

Selling Practices

Special Study Recommendation: The S.E.C. should adopt rules to facilitate and re-enforce controls over selling practices. Such rules should require that customer account cards include such information as investment goals, occupation and type of service sought, should require that customer complaints be kept in a single file, available for inspection by the S.E.C. and self-regulatory bodies, and should require that retail transactions be designated as solicited or unsolicited. (Recommendation 3, Ch. III—B, p. 329.) (See also the Comment on Rule 411 above.)

Special Study Comment: Commission inspections of broker-dealers may fail to detect illegal selling practices. Since a broker-dealer is not required to note whether a particular transaction has been solicited, the S.E.C. is unable to determine whether customers have purchased securities on the recommendation of the salesman. A requirement that customers' complaints be kept in one readily available file might aid the detection of improper selling practices. (Ch. III—B, p. 305.) The Commission should be empowered by rule to oversee selling practices in general.

Commission Comment: "[Recommendation 3] . . . involving selling practices falls most clearly within our rule-making power and would require designation of retail transactions as solicited or unsolicited, filing of customer complaints, and information as to the investment goals of the customer." (S.E.C. Special Market Study Release No. 25, April 30, 1963, pp. 4, 5.)

Exchange Comment: The Exchange's present rules require that essential facts about a customer and his orders be ascertained. Other Special Study proposals—for example, that permanent files

be maintained—are commonly practiced by responsible organizations within the industry. To the extent that they are not, appropriate steps can be taken by the self-regulatory agencies. Still other Special Study proposals—such as the suggestion that every retail trade be designated as solicited or unsolicited—might be virtually impossible to administer because of the variety of intangibles that lead up to each investment decision.

As to methods of handling customer complaints, conversations between the S.E.C. and the self-regulatory agencies have been and are continuing to take place. The Exchange is prepared to revise its rules or practices should the need arise. The recommendations clearly fall within the purview of the self-regulatory agencies where responsibility can be exercised effectively.

Officially Filed Disclosures

Special Study Recommendation: Self-regulatory agencies and the S.E.C. should define what obligations broker-dealers have in using officially filed disclosures by issuers. These obligations might include: (1) consulting available officially filed data prior to recommending or selling specific securities, (2) furnishing copies to customers and (3) advising customers whether such information is available. (Recommendation 5, Ch. III—B, p. 329.)

Special Study Comment: "The Commission counts as conduct which may be considered to violate the obligation of fair dealing the distribution of market letters or other sales promotional material which makes exaggerated and unsupported predictions of prices or earnings or omits material information, or implies the existence of a nonexistent research staff, as well as the practice of trading against investment advice." (Ch. III—A, pp. 239, 240.)

In addition, the Special Study cites a 1961 survey of 198 analysts which revealed that most of them "seldom" or "only occasionally" used such reports filed with the Commission as a major source of financial information. (Ch. III—C, p. 355.)

Exchange Comment: Although the Exchange would be glad to discuss this point, it ought to be noted that the Exchange has continuously encouraged the use of these disclosures and has made appropriate information available whenever possible.

Investment Advice

Special Study Recommendation: Reckless dissemination of written investment advice should be prohibited by statute or by rules of the Commission and the self-regulatory agencies and be subject to civil liability in favor of customers. Investment advice, which fails to consider most recently filed disclosures of issuers, should be a factor in determining whether such advice is reckless. (Recommendation 4, Ch. III—C, p. 387.)

Special Study Comment: Published advisory materials, when recklessly prepared, or when too casually based on unfounded information, can start a chain reaction which may end in financial loss for many investors.

Commission Comment: "[Recommendation 4] in our opinion can be handled by rule. [Recommendation 4] in effect would prohibit reckless dissemination of written investment advice." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: The Exchange believes that high standards for investment advice are desirable. It is now studying appropriate guidelines.

Reserve Against Free Credit Balances

Special Study Recommendation: Broker-dealers should be required to maintain a reserve of 15% of the aggregate amount of free credit balances in the form of cash or short-term U. S. Government securities; or, if a lesser reserve is maintained, to charge the difference to net capital. They should also be required to give customers at least quarterly notice of the amount of such balances and to indicate that the balances may be withdrawn at any time; that they are not segregated and may be lent to other customers or used by the firm; that interest is not paid (or the circumstances where interest is paid); and that the firm's financial statements are available. (Recommendation 1, Ch. III—D, p. 415.)

Special Study Comment: Of the various types of customers' assets retained by broker-dealers, free credit balances are accorded the least direct protection under Federal or State law, or rules of the self-regulatory bodies. Losses of free credit balances resulting from fraud, defalcation or insolvency appear to have been small in relation to the great volume of transactions taking place, but certain protections not now generally provided, short of segregation, are both desirable and feasible. (Ch. III—D, p. 401.)

Commission Comment: The Commission accepted the "underlying principle" of the recommendation, but indicated that it wished to hold a conclusion in abeyance and bring it to Congress at a later date. (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: A requirement that broker-dealers maintain a reserve against free credit balances will not result in any significant additional protection to investors, could be difficult to enforce and might create an undue burden on the industry. Exchange experience confirms that its net capital rules, effectively enforced and with appropriate minimum capital requirements, are designed to give adequate protection to investors. (See Exchange Comment under Rules 446, 466, 467.)

The Exchange encourages its members to render regular statements to customers and has not found it necessary to adopt a formal requirement. It does not believe that the information which the Special Study recommends be included in statements would result in a significant increase in protection for investors.

Custody of Customers' Securities

Special Study Recommendation: The Commission should be empowered to adopt rules requiring that excess margin and fully paid securities be segregated and marked in a manner which clearly identifies the interest of each individual customer. (Recommendation 2, Ch. III—D, p. 415.)

Special Study Comment: The Commission should adopt rules requiring segregation of customers' securities to assure uniformity of standards with respect to custody thereof. The Study states: "A Commission rule, like its capital ratio rule, presumably could exempt firms that, as members of self-regulatory bodies, are subject to a rule of at least equal stringency." (Ch. III—D, p. 404.)

Commission Comment: The Commission accepted the "underlying principle" of the recommendation, but indicated that it wished to hold a conclusion in abeyance and to bring it to Congress at a later date. (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: The Exchange does not believe that, with respect to its members, a rule requiring segregation of customers' securities is essential since segregation is a customary practice and is checked in the course of inspections by Exchange examiners.

The Exchange recognizes, however, that the adoption by the S.E.C. of generally-applicable rules requiring segregation of customers' excess margin and fully paid securities might promote uniformity of standards and offer further protection to the investors. If such rules are adopted, the Exchange agrees that there should be an exemption for firms subject to a rule, at least equally stringent, of a self-regulatory organization. Such an exemption would permit the Exchange to adopt and enforce its own rules and would accord with the principle that maximum scope should be given to self-regulation wherever it can meet the regulatory need.

Amendments to Bankruptcy Act

Special Study Recommendation: Section 60(e) of the Bankruptcy Act should be amended in certain respects to provide greater protection for customers in the event that an insolvent broker-dealer is adjudicated a bankrupt. (Recommendation 5, Ch. III—D, p. 416.)

Special Study Comment: The net capital ratio rules of the S.E.C. and certain exchanges have been a valuable protection for investors in preventing insolvency of broker-dealers. Nevertheless, customers whose securities or free credit balances are appropriately segregated should have greater protection. (Ch. III—D, p. 416.)

Commission Comment: Recommendation 5 is technical in nature. "We would prefer to bring [it] to Congress at a later date." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: The Exchange is not in a position to comment on the advisability of specific amendments to Section 60(e) of the Bankruptcy Act, at least until it has had an opportunity to study proposed legislative revisions. However, it is not opposed to clarification of those provisions of the Act where ambiguities now exist, nor is it opposed to the principle of greater protection for customers in the event of an adjudication of bankruptcy of a broker-dealer, provided that any such revision does not impose undue administrative burdens or result in unwarranted or excessive costs of doing business.

Broker-Dealer Director Conflicts

Special Study Recommendation: The self-regulatory agencies should consider the conflicts of interest of a broker-dealer who is a corporate director while engaging in interdealer and retail transactions in the corporation's securities. (Recommendation 1, Ch. III—F, p. 440.)

Special Study Comment: This is an area where the self-regulatory agencies should institute more positive continuing programs for the study of important problems of conflicts of interest in the securities business. (Ch. III—F, p. 440.)

Commission Comment: "This is a general rather than specific recommendation which we and the self-regulatory organizations should pursue." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 5.)

Exchange Comment: Rules 3(d) and 186 reflect the Exchange's vital concern with potential abuses that could arise from conflict of interest situations involving its membership. The Special

Study's recommendation is addressed to a broader field of conflict than either of these rules. The Exchange intends to continue to urge its membership to take appropriate steps to preclude conflicts of interest, but questions whether this is a matter which, in view of established fiduciary concepts, can properly be resolved by Exchange rules.

Exchange Act Rule 10b-6

Special Study Recommendation: The S.E.C. should clarify the application of Exchange Act Rule 10b-6 in a variety of situations. (Recommendation 8, Ch. IV—B, p. 559.)

Special Study Comment: The applicability of Rule 10b-6 to the retailing and advisory activities of underwriters or other broker-dealers holding investment positions, both in the period when the investment remains "locked-up" and when disposition is undertaken, would appear to be in need of clarification in view of the conflicting understandings and practices of different firms. (Ch. IV—B, p. 545.)

Commission Comment: "We agree with [Recommendation 8] that the Commission should take appropriate steps to clarify the application of [Rule 10b-6] and shall take the necessary action." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 6.)

Exchange Comment: Few areas pose as many interpretive problems as those involving the application of Exchange Act Rule 10b-6 in connection with trading on the Exchange and with regard to permissible activities by Exchange member firms. Any clarification of the application of Exchange Act Rule 10b-6 by the Commission would be a welcome and useful tool to the Exchange in the surveillance of Exchange trading and administration of its rules. Clarification of the Rule would also assist Exchange members in the course of handling customer orders that may involve a distribution.

Unregistered Distributions

Special Study Recommendation: Any broker-dealer managing an unregistered distribution of securities should be required to file with the Commission certain information in connection therewith. (Recommendation 1, Ch. IV—C, p. 569.)

Special Study Comment: Unregistered distributions are taking place with greater frequency and in greater quantities. Yet they occur, for the most part, without the minimum disclosure protections that would seem practicable and with a speed that does not permit careful consideration of the merits of the security being offered.

Commission Comment: "We accept in principle the concept of notifying the Commission of these types of distributions for the purposes of information and enforcement. However, with respect to . . . the balance of the first recommendation . . . we are inclined to hold . . . [it] in abeyance for further consideration." (S.E.C. Special Market Study Release No. 25, April 30, 1963, pp. 6-7.)

Exchange Comment: The Exchange believes that this recommendation bears further study. Although it does not oppose the principle of disclosure suggested by the Special Study, it recognizes that any delay in secondary distributions resulting from the filing and review of information with the S.E.C. could have serious consequences.

Market Openings

Special Study Recommendation: The A.S.E. should adopt rules designed to prohibit specialists from participating in openings in such manner as to upset the public balance of supply and demand. The policy of such rules would be that opening prices should move, from the previous close, in the direction dictated by public supply and demand, and not against it. (Recommendation 5(a), Ch. VI—D, p. 168.)

Special Study Comment: The specialist has too much discretion in determining whether to participate in the opening, and to what extent. In addition, too much emphasis is placed on factors other than supply and demand in determining the opening price. These factors include anticipation of price movements based on indications from a specialist's book, tone of the market, and news involving the particular issuer or industry group.

Commission Comment: We agree with Recommendation 5 ". . . which calls upon the exchanges to refine the obligations of specialists . . ." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 2.)

Exchange Comment: The Exchange does not believe that the Special Study intended that this recommendation be given a literal translation. Consider, for example, the following not uncommon situation: At the close, the price of a stock was 30 and there were orders on the book to buy 200 shares at 28. If orders to sell 200 shares at the market appeared at the opening the next day, they would, under the Special Study's recommendation, trigger transactions which, except for specialist participation, would result in a substantial and disorderly downward change in price.

Experience indicates that opening prices, determined solely by public supply and demand, without the aid and intervention of specialists, would be inconsistent with the obligation of a specialist as set forth in the Saperstein Doctrine. (Securities Exchange Act of 1934, Release No. 1117.)

Specialists' "Reaching Across the Market"

Special Study Recommendation: The A.S.E. should adopt a rule limiting the ability of specialists to "reach across the market", i.e., buying at the offer or selling at the bid, whether such transactions are to establish or to liquidate a position. Provisions should be made for exemptions from such rules with approval of floor officials and for systematic review by the floor departments. (Recommendation 5(b), Ch. VI—D, p. 168.)

Special Study Comment: "Reaching across the market" ordinarily establishes a new price level or widens the quoted market, whereas if a specialist waits for someone else to trade with him, he is less likely to establish a new level. "For example, the quote may be 50 bid, offered at 51, with the last sale at 50½ and with the specialist as broker bidding for 200 shares at 50 for the book. If the specialist sells 100 shares for his own account, to the book at 50, he creates a new price; if he 'cleans up the book' by selling it 200 shares, the next bid may be at 49½, and thus he has widened the quote." (Ch. VI—D, p. 80.)

Exchange Comment: "Reaching" is defined as the election by the specialist to buy at the public offer or sell at the public bid, within the crowd or to the book. Exchange Rule 174 requires that each transaction a specialist effects for his own account affirmatively meet a need of the market. "Reaching" trades may sometimes be necessary for a specialist to adjust his position in anticipa-

tion of a changing market. For example, believing that public buying will increase, he may have to buy at the offer in order to acquire sufficient stock to accommodate the anticipated orders. A specialist may also have to make a "reaching" trade in order to offset the purchase or sale of an odd-lot.

The aim of the proposed rule is presently embodied in A.S.E. Rule 174. In support of this Rule, the Exchange's procedures call for a daily review of specialists' activities, including a measurement of "reaching" transactions. As a result, the Exchange believes no formal rule as to "reaching" is necessary and that the adoption of such a rule might be unduly restrictive.

Rules Emphasizing Continuity with Depth

Special Study Recommendation: The A.S.E. should adopt rules relating to specialists trading as dealers. With respect to the general obligation of specialists to participate to the extent reasonably necessary to maintain a fair and orderly market, such rules should give emphasis to the concept of reasonable continuity with depth, i.e., participating with reasonable volume at each price level, and should also make clear that the obligation to participate requires that all quotations be reasonable ones in view of market conditions. (Recommendation 5 (c), Ch. VI—D, p. 169.)

Special Study Comment: Markets that exhibit only technical price continuity, but lack depth, detract from the worth of quotations and previous sales as indications of value. "A responsibility to provide continuity with depth is the reasonable concomitant to the many privileges specialists enjoy." (Ch. VI—D, p. 126.)

Exchange Comment: The Exchange agrees that a fair and orderly market is one that has both continuity and depth. However, the Special Study recommendation points to the difficulty of formulating hard and fast rules. The suggestion, for example, that specialists participate more actively and aggressively seems to contradict other conclusions in the Study that they frequently over-participate. This apparent contradiction can be explained only if each specialist and each stock is judged on his or its own merits, in view of the market existing at a particular time.

In any event, continuity with depth is part of the concept of a fair and orderly market and the Exchange believes that this end can be furthered by standards or tests being developed under Rule 174 rather than by additional rules.

Specialists' Investment Accounts

Special Study Recommendation: The A.S.E. should adopt rules requiring that each specialist unit maintain a single trading account. Implicit in this recommendation is the elimination of specialists' long term investment accounts. (Recommendation 6, Ch. VI—D, p. 169.)

Special Study Comment: The existence of long term investment accounts (1) is inconsistent with the Saperstein Interpretation, (2) makes the specialist an investor, thereby giving him a motive to support the market, (3) represents an unfair use of the specialists' exemption from margin requirements and (4) is subject to strong possibilities of abuse without any corresponding public benefit or means of effective regulation.

Commission Comment: ". . . we accept the principle that all securities in which a specialist is registered should be maintained in a single trading account." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 2.)

Exchange Comment: The Saperstein Doctrine states that all transactions for the account of a specialist are prohibited except those reasonably necessary to permit the specialist to maintain a fair and orderly market.

The existence of long term investment accounts is not inconsistent with the Saperstein Doctrine if the acquisition of stock by a specialist is solely for the purpose of maintaining a fair and orderly market. For an A.S.E. specialist to acquire stock for any other purpose is contrary to Rule 174.

The Exchange examines records of specialists' total inventories in each stock in which they are registered and makes no distinction between shares held for trading and shares held for investment. A specialist's performance is weighed against his total inventory and the market existing at a particular time. Exchange policy prohibits a specialist from selling short when he has stock in inventory, regardless of the account in which the stock is held.

Since Exchange policy requires specialists to supply stock, including stock held in an investment account, if necessary to maintain a fair and orderly market, any benefits derived from a specialist's exemption from margin requirements would be incidental.

The statement that long term investment accounts are subject to possibilities of abuse can only refer to a specialist withholding stock to the detriment of the market for the purpose of realizing a tax advantage. However, such withholding is contrary to Exchange policy, and this reason has no substantive basis unless it can be shown that such policy is not enforced by the Exchange.

The Study cites no instances where a specialist has withheld stock to the detriment of the market in order to obtain the tax advantages resulting from long term investment.

If while complying with Rule 174, a specialist does hold stock for six months or more, he is entitled to capital gains tax treatment. To establish the long-term gain, he is required by tax authorities to hold such stock in a separate investment account. Thus, if the recommendation were adopted, he would be caught between requirements of separate arms of the government. Further study, if any, should include discussion with tax authorities to protect specialists from discriminatory tax treatment.

Defining Market and Limited Price Orders

Special Study Recommendation: The Exchange should adopt rules defining market and limited price orders and variations thereof and defining specialists' and floor brokers' responsibilities with respect to each type of order. (Recommendation 7a, Ch. VI—D, p. 169.)

Special Study Comment: The A.S.E. lacks sufficient rules governing the brokerage function of specialists.

Commission Comment: ". . . we agree that the exchanges should undertake steps to refine the obligations of specialists as brokers and clarify various related floor procedures." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 3.)

Exchange Comment: The Exchange periodically publishes a Guide to Rules and Practices Governing Floor Transactions for specialists, floor brokers and others concerned with the floor.

For several months the Exchange has been revising and updating this Guide. Definitions of market and limited price orders and the responsibilities of specialists and floor brokers in handling them will be considered in the new edition. The Guide constitutes a directive of the Exchange and is a basis for enforcement procedures and policies.

Specialists Ability to Handle Blocks

Special Study Recommendation: The N.Y.S.E. and A.S.E. should undertake studies, in conjunction with the S.E.C., as to methods or plans by which the capacity of specialists to acquire large blocks of stock within the framework of the auction market could be otherwise strengthened. Among other possibilities, consideration should be given to (a) the establishment of an exchange-administered capital fund from which specialists could borrow under appropriate limits and safeguards; (b) the establishment of a capital fund, through contributions from the brokerage income of all specialists, that would be administered by specialists' representatives and/or the Exchange itself and would be available for taking positions beyond the financial capacity of an individual specialist; or (c) establishment of a system of limited self-insurance by specialists as a group. (Recommendation 9, Ch. VI—D, p. 170.)

Special Study Comment: "The role of the institutional investors on the New York Stock Exchange has increased substantially over the last 10 to 15 years. The needs of these investors are sometimes different from those of the smaller investors because institutional transactions are more likely to involve a large number of shares. Blocks of shares are often too large to be readily and promptly absorbed or supplied through the routine procedures of the auction market, but not necessarily so large as to require the use of any special distribution or acquisition plan. The specialist, stationed in the center of the auction market, has an important role in the handling of blocks both as broker and as dealer." (Ch. VI—D, p. 128.)

Commission Comment: ". . . we accept the recommendation for further studies relating to the capacity of specialists to acquire larger blocks of stock." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 3.)

Exchange Comment: The Exchange agrees that a sound method for increasing the capacity of specialists for handling large blocks would strengthen the auction market. The Exchange will explore various possibilities.

Reports re Specialists' Capital

Special Study Recommendation: A.S.E. should be required to report to the Commission any indication that a registered specialist unit is in violation of its specialist capital rule or has received a margin call, and should adopt rules providing that any member firm which clears for or finances specialists may not terminate clearing arrangements or call for additional margin without adequate prior notice to the exchange. Where a specialist in financial difficulties cannot promptly secure additional capital sufficient to bring his account above the required margin maintenance, his stocks should be reassigned temporarily or permanently to units with capital adequate to handle them. (Recommendation 10, Ch. VI—D, p. 170.)

Special Study Comment: "It is imperative that the Exchange keep itself informed of specialists' financial condition on a current basis, and that stocks registered with specialists who find themselves financially unable to perform their dealer function adequately be promptly reallocated.

in order to assure the public the continuous benefits of specialists' performance." (Ch. VI—D, p. 164.)

Exchange Comment: Specialists are required to file three financial statements with the Exchange and are subject to field examination by Exchange examiners. Clearing agents for specialists report to the Exchange when a specialist's account has become under-margined. In addition, the Exchange maintains a continuing record for each specialist unit showing the amount of capital required to assume a position in ten units of each specializing stock. All specialists also are required to advise the Exchange of any financial arrangements entered into for the purpose of financing specialist activities. When a specialist encounters a capital problem, the Exchange takes prompt action to bring in additional assistance or to reallocate the stocks in which he is registered so that a continuous auction market may be maintained.

Although the Exchange will study these recommendations, including methods in keeping the S.E.C. informed, the existing procedures and protections appear to be sound and have been effective.

Study of A.S.E. Odd-Lots

Special Study Recommendation: The S.E.C. and the A.S.E. should jointly undertake studies of the methods and costs of handling odd-lots. (Recommendation 5, Ch. VI—E, p. 202.)

Special Study Comment: The Special Study's consideration of odd-lots was essentially limited to the N.Y.S.E. The Study noted that odd-lots on the A.S.E. are handled by specialists rather than odd-lot dealers.

Commission Comment: "We agree with recommendations of the Special Study relating to odd-lot activities." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 3.)

Exchange Comment: The Exchange will be glad to cooperate in studies regarding the methods and costs of handling odd-lots.

Short Selling Reports

Special Study Recommendation: The N.Y.S.E. and A.S.E. and possibly other exchanges should initiate systems of reporting that will provide more frequent information on the volume of short sales in particular stocks classified as between the public and the principal classes of members. Monthly data on the short interest should show corresponding information in the selected individual stock. In addition, exempt short sales, sales against the box, arbitrage and hedging should be indicated, if feasible. The Commission should designate information to be regularly furnished and the type of data to be made publicly available. (Recommendation 1, Ch. VI—H, p. 293.)

Special Study Comment: Aggregate data with respect to short selling tends to obscure the true significance of short selling. (Ch. VI—H, p. 292.)

Commission Comment: The Commission concurs that more refined and complete information as to short selling transactions is needed. (S.E.C. Special Study Release No. 33, July 23, 1963, p. 4.)

Exchange Comment: The Exchange believes experience with its forthcoming data processing system will indicate the feasibility and cost of refining short selling information.

Short Exempts

Special Study Recommendation: The exchanges should examine current procedures for marking transactions as "short exempts," and institute checks to assure that this marking is accurate, and thereafter the S.E.C. should review the procedures adopted. (Recommendation 2, Ch. VI—H, p. 293.)

Special Study Comment: "The Special Study's investigations suggest that there is some laxness in the observation of the Commission's short-exempt rules and that the records by which compliance may be checked are not adequate." (Ch. VI—H, p. 291.)

Commission Comment: "We concur . . . with [Recommendation 2] recommending a re-examination of the procedures with respect to the reporting of 'short-exempt' transactions." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 4.)

Exchange Comment: As in other areas, the Exchange has increased its surveillance of floor procedures, including the marking of transactions as "short exempts." As recommended, it intends to discuss these procedures with the Commission.

Plans For Automation

Special Study Recommendation: The Commission has a present and continuing responsibility to be informed of developments and potential developments with respect to automation. (Recommendation 1, Ch. VI—J, p. 358.)

Special Study Comment: Referring to the N.Y.S.E.'s interest in automation: "The possibilities of modern technology may go beyond mechanical arangements and involve such functional matters as the execution of some orders from off the floor. This does not mean that possible changes of this kind are necessarily desirable but it suggests that they ought to be objectively explored and evaluated. The public, through the Commission, has an interest in such exploration." (Ch. VI—J, p. 357.)

Commission Comment: "Some subjects, such as automation, are long-range in nature, far-reaching in impact, and require a continuing and more elaborate analysis of a development only in its infancy in the securities industry." (Transmittal Letter, July 17, 1963, Part 2, p. VII.)

Exchange Comments: The Exchange anticipates that the impact of automation on its communications, floor, transfer and delivery systems, and the potential benefits to member firms and to the public, will be great. The A.S.E. expects to initiate, early in 1964, an automated telephone quotation system. Other studies are under way, but are not sufficiently advanced to indicate the specific direction further programs will take. The Exchange is keeping the Commission apprised of developments and will cooperate with all concerned.

Coordinated Reporting

Special Study Recommendation: The Commission and the major exchanges should jointly undertake studies of the periodic reports filed with the respective exchanges and by the latter with the Commission, with a view to simplifying and coordinating the reports and maximizing their usefulness. (Recommendation 3, Ch. VI—J, p. 358.)

Special Study Comment: "At present the Exchange and member firms file many periodic reports on a variety of subjects, each of which is designed for a specific purpose. The processing of these reports does not make use in any substantial degree of modern data processing techniques. Also, since the reports cover different periods and are differently designed, the information they contain cannot be integrated to present a comprehensive picture of market trends or current transactions." (Ch. VI—J, p. 358.)

Commission Comment: ". . . the Commission agrees that the impact of automation on its operations and on the operations of the exchanges and of the member firm should be the subject of continuing study." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 4.)

Exchange Comment: The Exchange agrees that simplification of reports by members and coordination to the maximum practicable extent with other self-regulatory organizations and the Commission is an appropriate subject for a Commission-industry study.

Listing and Delisting Standards

Special Study Recommendation: Listing and delisting standards of the several exchanges should be re-examined to assure that listed securities conform to the kind of market that the particular exchange purports to provide. (Recommendation 1, Ch. VIII—B, p. 836.)

Special Study Comment: Adequate share distribution is important to maintain a reasonably continuous auction market of sufficient fluidity and depth. It is doubtful that "delisting" standards "equal to 20 percent of listing standards are in keeping . . . with the public interest." (Ch. VIII—B, p. 831.)

Commission Comment: ". . . we agree that the listing and delisting standards of the exchanges should be re-examined." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 6.)

Exchange Comment: The new Exchange listing standards and delisting criteria adopted in April 1962 (and characterized as "stricter" by the Study, Ch. XII—C, p. 583) are continuously under review. They appear to be generally consistent with the recommendations of the Study. They are intended to protect investors primarily by calling for timely and continuous disclosure of pertinent corporate information and by requiring that the floating supply of stock in the hands of the public meets criteria considered necessary for a national auction market. These standards, however, are designed to encourage listings of young and vigorous corporations which have characteristically been traded on this Exchange.

The Exchange's delisting criterion pertaining to adequacy of share distribution provides for the delisting of a common stock if the shares publicly held decline below 70,000 shares held by less than 250 holders. The 70,000-share yardstick is 35% of the original listing standard which requires a minimum public distribution of 200,000 shares among not less than 750 holders. The limited share distribution delisting criterion was adopted in the belief that it is a disservice to the investing public to continue dealings in a stock issue when the floating public share distribution has decreased to the point that a satisfactory auction market cannot be maintained.

Third Market

Special Study Recommendation: The third market, i.e., the over-the-counter market for the trading of listed common stocks, should be evaluated as to the advantages of competition with

reference to possible impairment of the depth of the primary market. (Recommendation 1, Ch. VIII—D, p. 910.)

Special Study Comment: The existence of such trading prompts inquiry into the basis for a market which appears to duplicate the function of the exchanges and into its particular structure and operation and impact upon the primary market. (Ch. VIII—D, p. 871.)

Commission Comment: "This conclusion [of Recommendation 1] calls for no action by the Commission." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 7.)

Exchange Comment: The Exchange believes that a continuous auction market providing liquidity, depth and narrow price changes between transactions is an essential mechanism for accumulating capital and is best served if all dealings in listed stocks are transacted in that marketplace. To this end, the Exchange has adopted several rules which, with appropriate exceptions, require that its members and member organizations execute on the Exchange transactions in stocks admitted to dealings.

Identification Of Market Makers

Special Study Recommendation: Broker-dealers who hold themselves out to other broker-dealers and others as being willing to deal in listed stocks as principal should be identified so as to accumulate data necessary to evaluate the third market. (Recommendation 2, Ch. VIII—D, p. 910.)

Special Study Comment: Each market maker is free to make a market or discontinue a market in a listed security at will, and its trading is subject only to regulations applicable to over-the-counter trading and not those governing trading on Exchanges. (Ch. VIII—D, p. 885.)

Commission Comment: ". . . the Commission agrees that additional data concerning the third market is necessary on a continuous basis. The exact content and amount of this data will be determined after further review and consultation with the affected persons." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 7.)

Exchange Comment: This recommendation is consonant with Exchange policies supporting the principles of disclosure of pertinent facts considered necessary for investor guidance. The Exchange believes that the identification of market makers in the third market is an integral part of further study of the third market, recommended above.

Competition Through Multiple Trading

Special Study Recommendation: By helping to promote the multiple trading of the regional exchanges, which has become the mainstay of their existence, S.E.C. policy has encouraged competition in the securities markets. The evidence points to the conclusion that the benefits of this competition outweigh any possible effects on the depth of the existing markets. (Recommendation 1, Ch. VIII—E, p. 951.)

Special Study Comment: In certain areas the regional exchanges have provided technological competition with the major exchanges; one current example of this is the automated centralized bookkeeping system in effect on the Midwest Stock Exchange. In a wider sense, too, the public

interest is served by maintaining and fostering competitive markets as distinguished from having excessive concentration in a very few markets. (Ch. VIII—E, p. 950.)

Commission Comment: "[Recommendation 1] represents an introductory approach to the problem of the regional exchanges with which we generally agree." (S.E.C. Special Market Study Release No. 33, July 23, 1963, p. 7.)

Exchange Comment: A number of companies whose capital shares are dealt in on the A.S.E. also have shares traded in other markets. The Exchange cooperates with other stock exchanges, and believes the continued development of regional exchanges as primary or local markets is important to the public.

The merit of competition among the registered stock exchanges, all of them functioning under a similar framework of statutory and regulatory requirements, is clear, provided this does not detract from the functioning of the primary market in the interest of public investors.

Standards for Corporate Publicity

Special Study Recommendation: Stock exchanges and the N.A.S.D. should establish high standards for the dissemination of corporate publicity. These standards might appropriately be embodied in statements of policy. (Recommendation 1, Ch. IX—C, p. 102.)

Special Study Comment: The Special Study reviewed many examples of exaggerated publicity in Chapter IX. While the Study does not call for an Exchange rule, it suggests the Exchange formulate a statement of policy to which each company would be expected to conform.

Commission Comment: "[Recommendation 1] recommends that stock exchanges and the N.A.S.D. should establish high standards for the dissemination of corporate publicity, and we shall take steps to encourage this proposal." (S.E.C. Special Market Study Release No. 25, April 30, 1963, p. 8.)

Exchange Comment: The Exchange has enunciated its timely and adequate disclosure policy on many occasions. As a practical matter, its policy is part of its working relationship with managements of companies whose securities are traded on the Exchange. There is, in addition, the possibility that such a statement could be included in the formal listing agreement provided that such a statement, which cannot foresee every contingency that might arise, does not prove too limiting in its actual operation. More important than any statement of policy, however, is continuing contact between the Exchange and issuers of listed securities to assure that information, in which the public has a warrantable interest, both favorable and unfavorable, is promptly released.

Convertible Bonds Under Regulation U

Special Study Recommendation: Regulation U should be amended so that loans collateralized by, or to purchase or carry, listed convertible bonds are subject to margin requirements similar to those on loans collateralized by stock to purchase or carry listed stocks. (Recommendation 4, Ch. X—D, p. 39.)

Special Study Comment: Convertible bonds present a special problem because Regulation U, which unlike Regulation T applies only to loans to purchase "stocks," leaves them free of margin

controls; banks may therefore extend credit on the security of either listed or unlisted convertible bonds, and even for the purpose of purchasing or carrying such bonds, on any terms that they wish so long as the "good faith" test of Regulation U is met. (Ch. X—C, p. 23.)

Commission Comment: ". . . recomendations in this area [security credit] including legislative proposals relate essentially to matters within the jurisdiction of the Board of Governors [of the Federal Reserve System]. 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 toward the resolution of the problems raised." (Transmittal Letter, August 8, 1963, Part 4, p. IX.)

Exchange Comment: The Exchange believes that all credit in the securities industry should be subject to the same regulatory standards under the security credit regulations of the Federal Reserve Board. Related recommendations in Chapter X deserve careful study from the same point of view.

Coordination Among Self-Regulatory Agencies

Special Study Recommendation: Further and continuing attention should be given to possibilities for coordinating efforts and allocating responsibilities in a more efficient and productive pattern, without limiting any self-regulatory agency's freedom to have special measures or programs for its own membership. (Recommendation 1, Ch. XII—J, pp. 738, 739.)

Special Study Comment: There appears to be a considerable overlap in responsibilities and duplication of effort among the various self-regulatory agencies. (Ch. XII—J, pp. 738, 739.)

Commission Comment: ". . . 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." (Transmittal Letter, August 8, 1963, Part 4, p. IX.)

Exchange Comment: In general, the A.S.E. favors further industry programs consistent with the goal set forth in the Special Study recommendation, and has already joined in preliminary discussion with representatives of the S.E.C. looking toward improved coordination.

The Exchange is participating in an industry testing program jointly administered by the A.S.E., N.Y.S.E. and N.A.S.D., minimizing the duplication of effort. The three organizations have also coordinated their investigations of complaints to avoid duplicate effort where feasible. In addition, A.S.E. Constitution Article VIII, Section 1, allows members to elect the N.Y.S.E. arbitration procedure in lieu of the A.S.E. procedure.

CONCLUSION

The Securities Exchange Act of 1934 confirmed the primary role of stock exchanges and national securities associations to regulate their own operations and the conduct of their members. The American Exchange feels that effective self-regulation is the key to orderly markets and a shield helping to protect these markets from intrusion by unscrupulous people whose methods or motives do not harmonize with the public interest.

The need to foster effective self-regulation within the industry is emphasized throughout the Special Study. This emphasis is proper and the Exchange believes that its rules and procedures as set forth in this statement present, as a whole, a sound system for self-regulation.

The Exchange recognizes, as indicated in its comments, the merit of many of the recommendations made by the Special Study. But the emphasis by the Commission on the need for careful discussions with industry representatives is proper. The Exchange has participated in these constructive discussions to date and will cooperate in all possible ways with the S.E.C., as well as with other industry organizations.

In the course of its reorganization, the Exchange has established a special unit to review all of its rules and policies. Careful and continuing consideration will be given to recommendations of the Special Study and to comments of the Commission as this work progresses.

The Special Study chapters are extensive and the most recent chapters have just become generally available. It will take some time for the membership of the Exchange and others throughout the securities industry to study and discuss the complete document. It is to be hoped that a consensus will develop through this period of study and discussion and as a result of conferences with S.E.C. officials. The comments of the Exchange made in this statement may, therefore, be subject to revision.

The legislative proposals now before the Congress are based almost entirely on conclusions and recommendations of the Special Study contained in chapters made public in April of this year. There has been time for the securities industry as a whole to study these chapters, for conferences involving industry spokesmen and S.E.C. representatives, and for the development of a firm point of view. Thus the Exchange is not hesitant in expressing its unequivocal support of this proposed legislation and in urging prompt enactment in the public interest.

EXHIBITS

TO STATEMENT
of the
AMERICAN STOCK EXCHANGE

INDEX TO EXHIBITS

Exhibit A—Reports of the Special Committee for Study of the American Stock Exchange.

Exhibit B—Memorandum concerning the proposed General Amendment of the Exchange Constitution.

Exhibit C—Resolutions delegating authority to the President and approval of his redelegation to other officers and employees.

Exhibit D—Program and Constitutional Amendments relating to associate membership.

Exhibit E—Exchange listing and delisting criteria, policies and requirements.

Exhibit F—Final Report of the Board of Governors Committee Re Possible Delistings.

Exhibit G—Requirements for original listing applications. Stocks—long term warrants—bonds.

Exhibit H—Applications subsequent to original listing.

Exhibit I —Application to list additional shares (of a class previously listed) to be issued pursuant to a stock dividend or split-up.

Exhibit J —Application to list additional shares (of a class previously listed) for stock option and stock purchase plans.

[Exhibit A]

SPECIAL COMMITTEE FOR STUDY OF THE AMERICAN STOCK EXCHANGE

INTERIM REPORT

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REPORT ON STANDARDS FOR LISTING SECURITIES

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FINAL REPORT

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December 21, 1961

INTERIM REPORT TO THE PRESIDENT AND BOARD OF GOVERNORS OF THE AMERICAN STOCK EXCHANGE

On October 12, 1961, the President of the American Stock Exchange appointed, with the approval of the Board of Governors of that Exchange, a Special Committee of nine members:

> "to make a comprehensive review of the organization, rules, policies and procedures of the Exchange and to recommend such revisions, additions or eliminations which it believes would increase the effectiveness of the operations of the Exchange and enhance the service to the public."

In view of subsequent developments and the nature of its findings and conclusions reached after two months of intensive study, the Committee has decided to submit its recommendations regarding the organization and administration of the Exchange at this time. Subcommittees are continuing detailed studies of rules, policies and procedures and the Committee will make further recommendations at a later date.

The Committee is of the unanimous opinion that a fundamental revision of the organization of the Exchange and its administrative machinery is necessary and should be undertaken without delay. The Committee has come to this conclusion following a careful review of the existing organization, including the allocation of policy-making and administrative responsibilities. The paramount consideration of the Committee has been, and will continue to be, the public interest.

The growth of the Exchange has been dramatic. The number of issues listed on the Exchange has increased from 777 to 1,005, and the volume of shares traded annually from 111,626,218 to more than 475,000,000, over the past ten years. Within the same period, while the number of regular members has remained the same at 499, the number of associate members has increased from 307 to 411. These facts make it clear that the administration, staff and membership of the American Stock Exchange have a broad public trust. Their actions at all times must both seem and be right. Those in positions of authority at the Exchange should not tolerate any deviation from this mandate.

The most immediate problem confronting the Exchange is the selection of a new President. It may be difficult to fill the office until the details of any reorganization are

known. The issuance by the Committee of an interim report at this time reflects concern over that problem.

General Conclusions

The American Stock Exchange should be organized, governed and administered in a manner consistent with the public interest and the national scope and impact of its business. Its existing organization, including reliance on an awkward committee system, is inadequate. The changes recommended are proposed as a blueprint for a responsible and representative government for the Exchange operating through a compact and flexible management structure. The broad objectives are:

(1) to establish a Board of Governors which will represent all segments of the membership as well as the public-at-large on a properly balanced basis and be the sole policy-making body;

(2) to center all administrative authority in the President with an adequate staff responsible directly to him;

(3) to provide a constitutional framework rigid enough to insure the above division between policy and administrative responsibilities, but also flexible enough to permit prompt and decisive action by the Exchange as required in the public interest;

(4) to secure for all firms doing business on the Exchange an opportunity to be represented by direct ownership interest and the right to vote.

CONCLUSIONS AND RECOMMENDATIONS

Composition of the Board of Governors

The Board of Governors should include representatives of organizations doing business for the public in all parts of the United States. The Exchange should obtain the services on the Board of the ablest members of the entire community. The existing Board composed of 32 Governors (a Chairman, the President, fifteen regular members, twelve representatives of member organizations doing business for the public and three representatives of the public) should not be changed in size. It should, however, reflect the diversity of interests of the membership and investors represented by the membership.

The 27 Governors, in addition to the Chairman, President and the three public representatives, would be selected to fill the following categories:

1. Twelve regular members of the Exchange residing and having their principal places of business within the Greater New York Area, of whom not less than ten would spend a substantial part of their time on the Floor of the Exchange and of whom not less than six would be general partners of member firms or holders of voting stock in member corporations doing business for the public.

2. Eight general partners of member firms or holders of voting stock in member corporations doing business for the public, residing in and having their principal places of business within the Greater New York Area.

3. Seven general partners of member firms or holders of voting stock in member corporations, doing business for the public residing and having their principal places of business outside the Greater New York Area.

The 27 Governors referred to above should be elected by the membership for terms of three years on a staggered basis as at present. After serving two consecutive terms in whole

or in part, no Governor should be eligible to succeed himself except after an interval of three years. This proposal reflects the criticism that the Exchange is run by a "self-perpetuating" group.

The duties and functions of the Board would be as follows:

(1) to select the President and stipulate the terms and conditions of his employment;

(2) to formulate policies to be administered by the President and his staff;

(3) to adopt and amend rules;

(4) to review the administration and management of the Exchange and its affairs; and

(5) to pass upon disciplinary matters affecting members, member organizations and partners or stockholders of member organizations.

A number of these functions are presently assigned in whole or in part to Standing Committees. They should be the responsibility of the Board of Governors itself. It is contemplated that questions of policy would be reserved for monthly meetings which can be attended by out-of-town Governors, while interim matters not involving policy changes might be acted upon in meetings attended by Governors located in the Greater New York Area.

Chairman of the Board

The Chairman of the Board should be an outstanding regular member of the Exchange. As presiding officer of the Board, he should concern himself with the formulation of policy rather than execution of it. He should be a member, ex-officio, of any subcommittee of the Board, and should have the power, subject to its approval, to appoint members of all committees authorized by the Board to consider matters pertaining to the administration and policies of the Exchange affecting members and member organizations.

President

The President should have complete responsibility for administration of the Exchange and carrying out constitutional provisions and policies set forth by the Board of Governors. The staff should be solely responsible to the President. In general, the organization and administration of the Exchange would conform to the corporate type of organization and would minimize the possibility of rivalry between the President and the Chairman. The President would:

(1) represent the Exchange in all public matters, including relations with the government;

(2) appoint, subject to its approval, all committees authorized by the Board to consider public matters;

(3) appoint, subject to approval of the Board, one or more Vice Presidents, a Treasurer, a Secretary and such other officers of the Exchange (except the Chairman and Vice-Chairman) as he determines are required for efficient management of the Exchange, and fix the duties and conditions of employment of such officers and, subject to Board approval, terminate their employment at any time;

(4) appoint all other employees of the Exchange, fix their duties and conditions of their employment, and terminate their employment without approval of the Board;

(5) appoint, subject to approval of the Board, general counsel for the Exchange and such other professional advisers as he may consider necessary for efficient administration of the Exchange.

The President would be a member, ex-officio, of any subcommittee of the Board.

Independent Counsel

The Exchange should retain independent counsel from outside the organization. See above for appointment of counsel.

Elimination of Standing Committees

Experience with the existing committee system has demonstrated its inherent weaknesses:

(1) it results in a division of authority and an absence of well-defined responsibility;

(2) in certain basic areas standing committees tend to assume greater powers than are exercised by the President or the Board;

(3) policies developed by standing committees are often presented to the Board in such a manner that it is unable to make informed judgments;

(4) the system delays decision upon difficult problems, particularly disciplinary matters; and

(5) it has proved an obstacle in the development of necessary staff initiative.

Accordingly, it is recommended that all Standing Committees be eliminated.

Steering Committee

It is proposed that the Board create a Steering Committee of Governors to be selected on a rotating basis with the following responsibilities:

(1) to consult with and assist the President and staff in the administration of rules and policies promulgated by the Board of Governors or set forth in the Constitution;

(2) to make recommendations to the Board on policy matters submitted by the President or initiated by members of the Board, but not to make or change policies;

(3) to pass on disciplinary matters under limited powers delegated by the Board, but not on matters punishable by suspension or expulsion of a member, member organization or partner or stockholder of a member organization; and

(4) to review, at the request of members, member organizations or partners or stockholders of member organizations, or listed companies, any decision of the staff. If the Steering Committee determines that a decision of the staff should be reversed, the President should have the right to designate the matter for consideration by the Board itself.

It is recommended that the Steering Committee consist of three Floor Governors and two Office Governors. One of the Floor Governors should be an individual representing an organization doing business for the public. Members of the Steering Committee should serve for terms of not longer than three months and should be appointed by the Chairman, with the approval of the Board, on a rotating basis.

Certain functions now assigned to Standing Committees and customarily not associated with administration should be reassigned as follows:

Admissions

Admission to membership in the Exchange and member organizations should be the direct responsibility of the Board of Governors. The Board should be concerned with the character, integrity and background of applicants. It should authorize the Steering Committee or a similar subcommittee of Governors to cooperate with the staff in making investigations, to interview applicants and to submit recommendations to the Board.

Arbitration

The duties of the existing Committee on Arbitration should be assigned to a member of the Exchange staff. A panel of arbitrators would be appointed by the Chairman with the approval of the Board.

Supervision on the Floor

A number of functions of the Committee on Floor Transactions should be assigned to Floor Governors and other regular members active on the floor. Other duties of that Committee are administrative functions which should be assigned to the staff. The Committee will make specific recommendations on matters affecting floor procedures and trading rules in a subsequent report.

Listings

The listing and delisting of securities on the Exchange should be the responsibility of the Board itself. Specific recommendations as to listing requirements and their administration will be made by the Committee in a subsequent report.

Supervision and Conduct of Members and Member Organizations

The Committee will make recommendations concerning supervision and conduct of members and member organizations at a later date.

Finance and Public Relations

The duties of the Finance and Public Relations Committees should be assigned to the President and staff. The President should be responsible for preparation and presentation to the Board of an annual estimate of Exchange income for the succeeding year and recommendations as to appropriations for expenses. Additional recommendations as to appropriations would be made when necessary. As spokesman for the Exchange in public matters, the President should have control and responsibility for public relations.

Expansion of Staff

The present staff is undermanned in terms of existing duties and would clearly be inadequate to undertake the expanded responsibilities contemplated by this report. The new President should take immediate steps to organize an adequate staff. It is expected that present staff members would form the nucleus of officers and employees under the new organization.

Nominating Committee

The present method of selecting members of the Nominating Committee is cumbersome. Its members should be nominated by the preceding Nominating Committee at the same time that the Chairman and members of the Board of Governors are nominated. The size and composition of the Nominating Committee would remain unchanged.

Associate Membership

The regular members of the Exchange number 499. Of this group 312 members are partners or voting stockholders of member organizations. The Exchange also has 398 associate members all of whom, through their associate memberships, enable their member organizations to pay reduced commissions on business done on the Exchange.

Firms receiving the benefits of Exchange facilities and subject to its regulatory jurisdiction should have all the rights and obligations of full membership, including the right to vote for its management. The Committee is studying the feasibility of a procedure to enable qualified associate members to become regular members on a basis that is fair and equitable to members in both categories, and will submit its recommendations in a later report. In the interim, the Committee recommends that no new associate members be admitted.

Proposed Amendments and Procedures

Under the existing Constitution the Nominating Committee is required by January 8, 1962, to nominate a new Chairman and candidates for nine vacancies on the Board of Governors. The annual election of the Exchange is scheduled for February 12, 1962, the new Chairman and Governors taking office immediately thereafter. Under the Constitution there is no way to postpone this procedure.

It is hoped that the Nominating Committee will note the recommendations of this report and consider individuals who fit into the proposed classification of Governors.

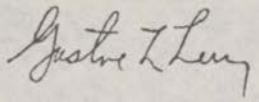
Since the implementation of Committee proposals would require several constitutional amendments, the Board should establish machinery for their submission to the membership. Prompt action is urged.

The Committee recommends that the Board of Governors include among constitutional amendments one calling for a special election to be held within 45 days after revision of the Constitution. The amendment would preserve the existing system of staggered terms for Governors. Procedurally it might provide for recomposition of the Board as proposed in the report and for a special Nominating Committee to be elected by the membership. That Committee would nominate a Chairman and a complete Board of Governors from among those who may be eligible whether or not they are then serving as Governors.

The Committee further recommends that the Board immediately appoint a committee to seek a new President of the Exchange.

The Committee is proceeding with its studies and will announce as promptly as possible its findings in matters not covered in this report. It is urged that the Board of Governors take immediate action consistent with these recommendations.

Respectfully submitted,



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January 30, 1962

REPORT TO THE PRESIDENT AND BOARD OF GOVERNORS OF THE AMERICAN STOCK EXCHANGE ON STANDARDS FOR LISTING SECURITIES

The Special Committee for Study of the American Stock Exchange herewith reports its conclusions and recommendations to the Board concerning standards for listing securities on the American Stock Exchange.

The Exchange performs an important economic role in providing a national auction market for the sale of securities of soundly established, publicly held companies which may not meet some of the size and other requirements for listing on the New York Stock Exchange. Although the Exchange itself has grown in size and in national importance in recent years, some of its listing standards today do not reflect the changing times and the need for wider protection for the investing public. The Exchange has recognized this need and in recent months has promulgated certain new rules to provide this protection and offer a better quality of market for trading. The Committee believes that this is a step in the right direction. It also urges that a number of additional steps be taken in the same direction.

Among other studies, the Committee has made a statistical analysis of the first ninety common stocks listed in 1961. The purpose of the study was to examine the extent of the application of listing standards then in effect and to assist in judging the effect of any proposed standards. Delisting standards, the personnel requirements of the Division of Securities of the Exchange, and listing fees were also considered by the Committee. The recommendations which follow are restricted to common stocks.

The Committee believes that adoption of its recommendations would foster public confidence in the Exchange and encourage many qualified companies to list their securities. The standards proposed are designed to assure that an orderly market can be maintained in all newly listed common stocks. The Committee has no desire, however, to make listing standards on the Exchange unnecessarily stringent, for it believes as many publicly held companies as possible should enjoy the benefits of an auction market.

The Committee urges that new standards adopted by the Exchange, whether or not recommended in this report, be announced publicly and rigidly applied. Listing standards which are elastic expose the Exchange administration to pressures from interested parties. Although the Committee recognizes the dangers of inflexibility, it believes that categories

of exception, if any, should be delineated in advance and not created upon the occasion. When a company satisfies the standards, however, its securities should not be automatically listed, but merely considered for listing.

CONCLUSIONS AND RECOMMENDATIONS

I. Standards of Eligibility for Original Listing of Common Stocks

Net Worth

Effective January 2, 1962, in order to list its stock on the Exchange, a company must have a net worth of at least $1,000,000. Provided that the new standard is rigidly applied, the Committee recommends continuation of it. Because the Committee believes that the concept of net worth is an inconclusive determinant of a company's financial strength, the Committee has added market value tests as indicated below.

Earnings

Effective January 2, 1962, in order to be considered for listing, a company must have net earnings for the preceding fiscal year of at least $150,000. The Committee finds the new standard of the Exchange satisfactory only if it is combined with a test for average earnings over preceding years.

An additional standard requiring an average of $100,000 in net earnings over the three preceding fiscal years would oblige the company with a sudden increase in earnings in its latest fiscal year to become more seasoned and demonstrate its earning power over a period of time prior to listing.

Certain exceptions to these tests are warranted, but should only be made when the company exceeds other proposed tests of size. The Exchange should consider applications of companies which do not meet the above earnings standards only in special situations such as: companies registered under the Small Business Investment Act; investment companies with substantial assets, including real estate investment companies; real estate companies with substantial assets and cash flow; and companies engaged in the construction of fully financed plants or other facilities which are able to demonstrate to the Exchange their ability substantially to exceed these earnings standards within a reasonable period of time.

Public Distribution of Shares

Effective January 2, 1962, in order to be listed, a company must have 200,000 shares in the hands of the public, exclusive of insiders' or concentrated or family holdings. The Committee recommends continuation of the new standard of the Exchange.

Total Number of Stockholders

Effective January 2, 1962, in order to be listed, a company's shares must be held by a minimum of 750 persons, including at least 500 holders of round-lots of the stock. Noting that this test is considerably more stringent than the one previously in effect, the Committee recommends continuation of the new standard by the Exchange.

Aggregate Market Value of Common Stock and of Shares in Hands of the Public

The aggregate market value of a company's outstanding common stock and particularly those shares in the hands of the public, are important determinants of the potential liquidity of the market. The Exchange has no requirement for a minimum market value of these shares as a condition of listing.

The Committee recommends that a company's shares in the hands of the public should have a minimum market value of $1,250,000. The test should be considered in conjunction with that proposed above for the number of shares to be held by the public. With a floating supply of only the minimum dollar amount there should be a potential of future distributions of concentrated holdings, which would improve the liquidity of the market. An additional standard of $2,500,000 for the aggregate market value of all common stock outstanding is therefore recommended.

Voting Rights

Except under certain circumstances, listing of non-voting common stocks is viewed unfavorably by the Exchange. The Committee recommends no change in this approach, urging that each case be studied on its merits.

Scrutiny of Management

Generally speaking, the newer and smaller the company, the less widely known is the business reputation of its management. The Exchange should have a staff adequate to make a careful scrutiny of the character of the management of those companies which apply for initial listing of their securities.

II. Listing Agreements and Subsequent Listing Applications

Quarterly Earnings Reports

An essential condition for a good public market in a security is that information necessary to analyze its merits is periodically available to investors. Important information is revealed in company balance sheets and income statements prepared by independent accountants. Although the Exchange now requires that reports of such audits be sent to shareholders before the annual meeting of the company, it does not require interim financial reports during the year. It is recommended that financial reports whether or not audited showing net income before and after taxes be submitted quarterly to the Exchange and made public by those companies whose stock would be listed subsequent to adoption of the proposal. It is further urged that within two years such reports be required from presently listed companies and those which are admitted to unlisted trading privileges. Delisting should automatically be considered when a company does not comply with these reporting requirements.

Solicitation of Proxies

At present proxy solicitation seeking shareholder approval is required by the Exchange as a prerequisite to (1) listing additional shares issued in certain acquisitions of property; and (2) to listing of shares under plans covering stock options to directors and key employees. In accordance with the concept of full disclosure and shareholder democracy, the Committee recommends that solicitation of proxies for all meetings of shareholders be a requirement of listing.

The requirement would apply to those companies whose stocks would be listed subsequent to adoption of the proposal, and within two years to those companies presently listed and those admitted to unlisted trading privileges. Delisting should automatically be considered when a company does not comply with the proposed requirement.

Stock Splits and Stock Dividends

Exchange standards do not expressly provide that low priced shares resulting from a stock split may be disapproved for listing.

Stock splits and stock dividends which cause a low trading range in a stock make large percentage fluctuations in its price difficult to control. In situations where adjustments result in such price ranges, the Exchange should consider disapproval of listing the new shares. It is suggested that an adjusted price of under 7½ be considered as unusually low.

Engraving of Certificates

The Exchange does not require at present that certificates of listed securities have engraved borders. Since the cost is minimal, stock certificates should have engraved borders to provide protection against forgery.

Acquisition of or Merger with an Unlisted Company

Consistent with its proposals for promulgation and application of rigid listing standards, the Committee urges that the Exchange consider disapproving additional listing of shares resulting from an acquisition, consolidation or merger which would in effect be an acquisition of a listed company by an unlisted company and circumvent initial listing requirements. In such a case, if the resulting company would not qualify for original listing, after weighing all relevant circumstances, the Exchange should refuse to list the additional shares of the listed company.

Listing of Shares not Registered under the Securities Act of 1933

In connection with listing of additional shares sold in a private transaction for investment, and not registered under the Securities Act of 1933, the Exchange has, since 1956, required in certain cases that the certificates for such shares be stamped to indicate that the stock has not been so registered. The Committee notes that this practice is not followed by other major exchanges which instead rely upon the opinion of counsel that such registration is not required. The Committee recommends that the Exchange study the practice in question with other stock exchanges from the point of view of effective compliance with the Securities Act. Moreover, compliance with the Act should be the proper concern not only of the Exchange, but of members and member firms.

III. Unlisted Trading

The Committee notes that in enacting the Securities Exchange Act of 1934, Congress permitted the continuation of unlisted issues traded on the Exchange as of that date. The number of such common and preferred stocks decreased from 800 in 1934 to 206 at the end of 1961. On the same date, there were 806 issues fully listed. At the end of 1960, the average price per share of unlisted common stocks was $28.21 compared to an average price per share of listed common stocks of $8.57. Although they accounted for only 12%

of the total share volume during 1960, at the end of that year unlisted common stocks had an aggregate market value of $13.8 billion compared to $9 billion for listed common stocks.

The Committee believes that certain of its proposed standards should apply to companies whose stocks are admitted to unlisted trading privileges. If within one year of adoption of the proposal these companies have not satisfied the proposed minimum delisting standards for public distribution, number of holders, market value, and earnings, and within two years have not commenced issuing quarterly financial reports and soliciting proxies for all stockholder meetings, the Exchange should automatically consider the withdrawal of unlisted trading privileges. It should attempt to persuade those companies which satisfy the enumerated tests to become fully listed.

IV. Standards for the Delisting of Common Stocks

The Committee is persuaded that it is a disservice to the investing public to continue trading a security on an exchange when the quality of market implied by the original listing can no longer be provided. Unless a review of the company and trading in its security indicates that its continued listing is in the public interest, the security should be delisted.

To replace the existing flexible delisting standards of the Exchange, the Committee proposes standards which generally represent 30% to 40% of the standards recommended for listing.

The stock should be considered for delisting if, exclusive of insiders' or concentrated or family holdings, there are less than 70,000 shares in the hands of the public.

Delisting should also be considered if the company's stock is held by less than 250 persons, or if less than 150 persons hold round-lots of the stock.

There is no present requirement for delisting the stock if the aggregate market value of all common stock outstanding falls below a dollar minimum. A minimum of $1,000,000 is proposed for this standard. In addition, a minimum market value of $500,000 for shares in the hands of the public is proposed as a standard for delisting the stock.

The Committee believes that a listed company should be able to maintain itself as a going concern. Unless there exist valid reasons for continued listing, the stock of a company which has not produced a net profit in one of the three preceding years should be delisted.

Before the recommended delisting standards are applied to presently listed companies, a careful study of the effect of the application should be made. Securities with no reasonable expectation of exceeding proposed delisting standards should be promptly delisted. Borderline cases which have good expectations of curing their deficiency in the near future should be granted a maximum period of grace of one year and be carefully scrutinized during that period.

V. Adequacy of Staff

The Committee calls attention to its Interim Report of December 21, 1961, which urges elimination of the Committee on Securities of the Exchange and assumption and effective exercise of responsibility for listing by the Board of Governors. The Committee reiterates the recommendation made therein that an adequate Exchange staff be organized. In the area of listing of securities, the staff should be sufficiently large and well qualified to examine thoroughly each applicant for listing and prepare the necessary analyses for the Board's consideration; maintain regular personal contact with the management of listed companies; insure that reporting requirements are promptly observed; and maintain a continuous surveillance of companies approaching delisting standards.

As an example, existing listing agreements should be administered so as to insure that companies submit required reports and proxy statements, and in sufficient quantity to

stockholders of record so that the material may be redistributed to all beneficial shareholders, and that announcement of dividend action or splits of stock be transmitted to the Exchange immediately following such action.

The Committee believes that to fulfil its economic function, a stock exchange must generate new listings of securities. It would be in the public interest and advantageous to many qualified companies to enjoy the benefits of a listed market. The Exchange should organize a separate staff group whose function would be actively to seek out such qualified candidates for listing and present the advantages of an auction market.

VI. Listing Fees

Fees imposed by the Exchange for listing securities are at present nominal. Irrespective of the number of shares listed, the original listing fee and fee for additional listings do not increase beyond $1,000, respectively. There is no continuing fee charged per annum.

The Committee believes that an increase of initial listing fees and establishment of a continuing fee on all newly listed shares would bring substantial additional revenue to the Exchange but would not be burdensome to listed companies. A schedule of proposed fees is set forth in the summary below.

VII. Summary Comparing Existing and Proposed Standards and Fees for Listing and Delisting Stocks on the American Stock Exchange

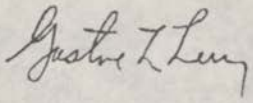
Item	Existing Standards	Standards Proposed by the Committee
1. *Standards for Original Listing*		
(a) Net worth	Net worth at least $1 million (before Jan. 2, 1962, a net worth of $1 million, but reduced to $750,000 for "low asset" companies)	Standard of Jan. 2, 1962 should be continued.
(b) Earnings:		
In latest fiscal year	$150,000 earnings after taxes with enumerated exceptions (before Jan. 2, 1962, net earnings of $100,000 with similar exceptions)	Standard of Jan. 2, 1962 should be continued with modified exceptions.
Average earnings over preceding years	None	$100,000 average earnings after taxes over 3 preceding years with similar exceptions
(c) Public distribution of shares	200,000 shares, exclusive of concentrated holdings (before Jan. 2, 1962, 100,000 shares)	Standard of Jan. 2, 1962 should be continued.

Item	Existing Standards	Standards Proposed by the Committee
(d) Total number of stockholders	750 holders, of whom 500 must hold round-lots (before January 2, 1962, a total of 500 holders of both)	Standard of Jan. 2, 1962 should be continued.
(e) Aggregate market value of common stock outstanding	None	$2,500,000
(f) Aggregate market value of publicly held shares	None	$1,250,000
2. *Listing agreements and subsequent listing applications*		
(a) Quarterly earnings reports, unaudited	None	To be submitted to the Exchange and made public by (1) newly listed companies; (2) within 2 years by presently listed companies and those with unlisted trading privileges; non-compliance would result in automatic consideration for delisting.
(b) Solicitation of proxies for all meetings of shareholders	A prerequisite to listing additional shares issued in an acquisition of property (1) in which insiders have an interest, or (2) which will result in an increase in outstanding shares of 20% or more. Since Jan. 2, 1962, also required for listing of new plans covering stock options to directors and key employees.	In addition, to be required from (1) newly listed companies; (2) within 2 years from presently listed companies and those with unlisted trading privileges; non-compliance would result in automatic consideration for delisting.
(c) Stock splits and stock dividends	Upon distribution of a stock dividend of less than 25%, a company is "expected" to transfer from Earned Surplus to Capital Surplus Accounts, an amount equal to the fair value of such shares.	In addition, where splits or stock dividends result in a low price range for new shares, Exchange should disapprove listing them. An adjusted price of under 7½ per share suggested as being unusually low.

Item	Existing Standards	Standards Proposed by the Committee
3. *Unlisted Trading Privileges*	No additional issues admitted to unlisted trading privileges	Unless the companies meet within one year the requirements proposed in 4, below, and within 2 years the requirements proposed in 2, (a) and (b), consideration should be given to withdrawal of trading privileges.
4. *Standards for Delisting*		*Less than*
(a) Public distribution of shares	30,000 shares (before Dec. 7, 1961, 20,000 shares)	70,000 shares
(b) Total number of stockholders	200 holders	Total of 250 holders, including 150 round-lot holders
(c) Aggregate market value of common stock outstanding	None	$1 million
(d) Aggregate market value of publicly held shares	None	$500,000
(e) Record of earnings over preceding years	None	Good reasons should exist for not delisting if there is no net profit in 1 of 3 preceding years.
5. *Listing Fees*		Fees Proposed by the Committee
(a) Initial listing fee	$1,000 flat fee (1¢ per share up to $1,000 on additional blocks)	½¢ per sh. for first 500,000 shs. ¼¢ per sh. for next 1,500,000 shs. ⅛¢ per sh. for over 2,000,000 shs. $1,000 minimum
Example:		
2,000,000 shares	$1,000	$6,250
(b) Continuing fee only for additional listings of presently listed and newly listed companies	None	1/20¢ per sh. for first 2,000,000 shs. 1/40¢ per sh. for over 2,000,000 shs. for 15 years
Example:		
2,000,000 shares	None	$1,000 for 15 years

The Committee is proceeding with other studies and will promptly announce its recommendations on those subjects. It is urged that the Exchange consider and put into effect as soon as feasible the standards proposed in this report.

Respectfully submitted,



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February 15, 1962

FINAL REPORT TO THE PRESIDENT AND BOARD OF GOVERNORS OF THE AMERICAN STOCK EXCHANGE

The Special Committee for Study of the American Stock Exchange has submitted two interim reports, one recommending basic changes in the organization of the Exchange and the other recommending new standards for listing and delisting of securities. The Committee has now completed its review of the organization, rules, and policies of the Exchange and submits its final report.

On January 3, 1962, the Securities and Exchange Commission released a staff report which emphasized the importance of the changes in the organization and administration of the Exchange recommended by the Committee in its first interim report. The Committee has considered the S.E.C. report as well as testimony of officials, members (including specialists and floor traders) and allied members of the Exchange, and has studied similar testimony taken by the S.E.C. staff. In addition, the Committee has studied the rules and policies of the Exchange.

Under the Securities Exchange Act of 1934, national securities exchanges, including the American Stock Exchange, are granted the primary responsibility for the regulation of conduct of their own members. The Exchange must assume that responsibility in a way entirely consistent with the public interest. Although the Exchange as an institution represents a broad community of firms and companies, the starting point is the individual, allied, or associate member. Thus the Committee has been gratified to find a recognition and acceptance of public trust by those who have testified.

Recent events have demonstrated the need for drastic internal changes. The solution of difficulties that have appeared, and the prevention of similar problems in the future, must commence with a revision of the organization and a strengthening of the management of the Exchange as previously recommended. When this is accomplished, a basis will exist for proper enforcement and self-policing.

CONCLUSIONS AND RECOMMENDATIONS

Supervision of Conduct and Enforcement of Rules

The reorganization recommended in the Committee's first interim report, eliminating the committee system and clarifying lines of responsibility, is the first and most important step the Exchange must take. Under the reorganization, which has been approved in

principle by the Board of Governors, administrative authority is to be centered in the President with a staff responsible solely to him. The Board is to be the sole policy-making body.

The Committee recommended that one of the Board's duties should be "to pass upon disciplinary matters affecting members, member organizations and partners or stockholders of member organizations." The Constitution should lodge responsibility for discipline with the Board and limit the areas within which it may delegate its authority. If the Board should delegate any of its responsibilities over discipline, a person or member organization affected by a decision of any officer, employee or committee acting under powers so delegated should be able to require review by the Board of such decision. Furthermore, the Board should in no case delegate the power to suspend or expel a member, member organization or a partner or stockholder of a member organization.

Certain standing committees are now authorized to impose fines not exceeding $250 for each offense within their jurisdiction. As part of the reorganization of the Exchange, standing committees would be eliminated. If the Board chooses to delegate the power to impose limited fines to the proposed Steering Committee, it should do so in a resolution which it can revise on the basis of experience.

Careful review indicates that the rules of the Exchange are comprehensive and generally satisfactory. Problems which have arisen stem largely from the failure to discover infractions of rules or other questionable practices and, when discovered, failure to discipline promptly those guilty of serious misconduct. The Committee recommends that the Exchange review the nature of disciplinary actions taken in the past for the purpose of ensuring that penalties assessed in the future are both effective and sufficiently severe.

All recommendations for surveillance of conduct and enforcement of rules made in this and earlier reports are keyed to the Committee's recommendation that the Exchange staff be adequate to undertake expanded responsibilities with clear authority. It must be large enough to look into the conduct of all segments of the membership, and be empowered to investigate any suspected infractions of rules, and interrogate members and others when necessary. The staff must be effectively supervised.

The responsibility for compliance with provisions of securities laws, both federal and state, falls upon the entire Exchange membership. A wilful violation by any person within its jurisdiction should be considered by the Exchange and be the subject of prompt action consistent with the elements of due process and fair play.

The Constitution provides that the Board may suspend or expel a member found guilty of "conduct or proceedings inconsistent with just and equitable principles of trade" or of any act "detrimental to the interest or welfare of the Exchange." The Constitution also provides that a member who wilfully violates the Securities Exchange Act of 1934 shall be deemed to be guilty of an act inconsistent with just and equitable principles of trade.

The Exchange in the past has taken the position that a violation of the Securities Act of 1933 is a matter beyond its jurisdiction. A wilful violation of the Securities Act of 1933 or of any other law, rule or regulation of governmental authorities should be subject to disciplinary action by the Board. It is recognized that the Board might defer consideration of conduct being questioned by another exchange, the National Association of Securities Dealers, S.E.C., or other governmental body, if concurrent action would not serve a useful purpose. The Board should, however, take affirmative action at the appropriate time.

Supervision of Members on the Floor

In its first interim report the Committee recommended elimination of the Committee on Floor Transactions, charged with supervision of members on the floor. The report stated:

> "A number of functions of the Committee on Floor Transactions should be assigned to Floor Governors and other regular members active on the floor. Other duties of that Committee are administrative functions which should be assigned to the staff."

Governors of the Exchange who are active on the floor must supervise and regulate active openings and unusual situations which may arise in connection with the making of bids, offers and transactions on the floor. Moreover, such Governors should consider as a group questions of policy which may arise concerning the operation of the floor and be in a position to make recommendations to the full Board of Governors.

To assist the Floor Governors, the President should appoint, subject to the approval of the Board, an auxiliary group of Floor Officials. It is recommended that this group consist of 10 members who are active on the floor, of whom at least five would be partners or stockholders in member organizations doing a public business. The President should consider appointing as Floor Officials some members who have not been Governors of the Exchange, but who might be expected in the future to be active in Exchange affairs.

Other administrative functions performed by the Committee on Floor Transactions should be assigned to the staff. There should be sufficient personnel to study reports submitted by specialists and others on a systematic basis; to develop data showing the daily carry-over of specialists; the percentage of their trades which are stabilizing; the continuity of markets, and the percentage of activity by specialists for their own accounts; to determine the activity of all specialists and members trading for their own accounts in a given stock on a given day; and to investigate any suspected irregularities on the floor.

Any infraction or questionable practice discovered by a Floor Governor or Floor Official should be brought immediately to the attention of the staff.

Supervision of Member Organizations

The Exchange's examination and inspection program, intended to ensure both proper conduct and compliance with capital requirements, has been limited to member organizations which are not members of the New York Stock Exchange. It is sound policy to avoid needless duplication, but the Exchange should be certain that a free flow of information between the two exchanges is encouraged.

The Exchange has recently brought all individual specialists, whether or not they are participants in joint accounts, under its examination and inspection requirements. The program includes specialists who clear through member organizations of the New York Stock Exchange. This program should be continued and expanded to include all specialist firms.

A member organization doing business with the public must submit financial questionnaires three times each year, and one must reflect the results of an audit by an independent public accountant. In addition, staff examiners inspect the books and records of these firms and those which do not do business with the public twice each year.

It is recommended that the annual audit be on a surprise basis and that the results of the audit be submitted directly to the Exchange.

Off-Board Trading in Listed Stocks

If members and member organizations are permitted to trade over-the-counter in common stocks listed on the Exchange, the tendency will be to decentralize the market and perhaps establish an eventual custom of trading listed securities on a net or negotiated basis. To the extent this occurred, the effectiveness of the auction market would be undermined and the advantages of such a market to the public would tend to diminish.

Rules of the Exchange now prohibit off-board trades by specialists. The Exchange should limit such trading by all other member and member organizations by a rule substantially as follows:

> "A member or member organization must obtain the permission of the Exchange before effecting any transaction in a listed stock or stock admitted to unlisted trading privileges off the floor of the Exchange, either as principal or as agent, except in stocks specifically exempted by the Exchange."

The Exchange should publish a list of securities which would be exempt. With respect to those stocks exempted, members and member organizations should review all proposed off-board transactions, with due consideration to the market on the floor, the price and the size of the market, and make every effort to effect transactions on the floor.

Floor Trading

Rule 110 of the Exchange, which restricts trading by members for their own accounts on the floor of the Exchange, makes it clear that members may not congregate in or dominate a stock, and specifically limits the extent of their trading. It is designed to minimize any advantage a floor trader might have over off-floor investors. A recent interpretation of the rule prohibits a member who has been present on the floor at any time on a given day from entering an order after having left the floor to establish or increase a position in any security.

The restrictions of rule 110 may account in part for the steady diminution in volume of floor trading. The S.E.C. staff report points out that in 1959, members participated in 4.3% of transactions on the Exchange in trades for their own accounts and in 1960 2.7% of the total. While the percentage is small, the role of the floor trader is very important in that his trades tend to stabilize prices, aid the markets during periods of stress, and contribute to the continuity and closeness of markets.

The Exchange, its members and member organizations are vitally concerned with the effectiveness of restrictions on floor trading by members for their own accounts. Members doing business off the floor or representing customers would oppose unfair advantages enjoyed by any group. Thus the Exchange has long been committed to careful examination of this area, and proper enforcement of the stringent provisions of rule 110 will serve the interest of the public and the membership.

The Exchange should make certain that daily reports submitted by members trading for their own accounts are analyzed and that violations of rule 110 are not tolerated. It should also be willing, as it has in the past, to modify the rule on the basis of experience. It is felt, however, that the Exchange should not unduly discourage any activity which contributes to the smooth functioning of the auction market.

Specialists

The success of the Exchange as an auction market depends in large measure on the effectiveness of the specialist. It is essential, in any discussion of regulations applicable to a specialist, to bear in mind his two key functions:

> (1) He must accept from other members, orders that are above or below the current market and assume the responsibility of executing them when the market level reaches

the prices designated. In doing so, he makes it possible for other members to conduct business elsewhere on the floor with the assurance that their orders are represented at the specialist's post at all times.

(2) He must maintain fair and orderly markets in the stocks in which he specializes by buying and selling for his own account whenever there is a disparity between supply and demand. In performing this function, the specialist must contribute to price continuity and the liquidity of the market, so that investors' orders are executed at the most favorable prices.

In acting in his dual capacity, the specialist makes the auction market work. He must be in a position to assume substantial risks. If no close bids or offers are present, he must be prepared to make both the best bid and the best offer at the same time. It he does not have enough stock in his inventory, he must be in a position to sell stock short in order to maintain an orderly market. Although certain limitations on his activities are proposed below, they are framed to grant the specialist the maximum freedom to perform his functions effectively.

Regulations now applicable to specialists do not need drastic amendment. Supervision of specialist activities has not proved effective, however, and should be a primary objective of the proposed new staff. No specialist should be approved who is not fully qualified.

Financing of Specialists, Competing Books, and Relief Specialists

Although the ability of the specialist to maintain an orderly market depends on many factors other than his financial condition, he must have adequate capital and financing arrangements.

The Committee has found that adequate facilities for financing and clearing for Exchange specialists are not readily available. This is probably due to the fact that a firm clearing for an Exchange specialist must clear both round-lots and odd-lots.

At present many specialists are financed and have clearing arrangements with clearing firms who also act as specialists on the Exchange.

The Committee believes that a specialist or member firm which has supplied a significant line of credit to another specialist could be in a position to influence the borrowing specialist's exercise of judgment as to transactions necessary to maintain an orderly market. It is also believed that in a case where a specialist firm has financed a number of specialists' accounts, if all should require substantial credit at the same time because of market pressures, both the financing specialist and those financed might be subject to extreme financial stress.

The potential dangers inherent in such arrangements indicate that steps should be taken to develop sound alternatives. It is recommended that the Exchange explore ways and means to develop added clearing and financing arrangements for specialists, perhaps through the modification of present American Stock Exchange Clearing Corporation procedures, to permit the use of facilities of commercial banks. The Exchange should also require specialists to obtain the necessary capital to carry on their normal operations effectively without sharing their profits with other specialists or members. This requirement would apply to any specialist registered after the rule is adopted and to specialists or joint accounts now registered within a reasonable time after it is adopted.

The minimum capital of specialists on the Exchange should be increased for all specialists, including joint accounts. The current standard of $10,000 or capital sufficient to carry four trading units in each stock is inadequate. Although four trading units amount to 400 shares in a 100 share unit stock, it is proportionately lower in 50, 25 or 10 share unit

stocks. It is recommended that each specialist or specialist unit have a minimum capital of $50,000 or an amount sufficient to enable the specialist to carry ten trading units in each security in which he is registered, whichever is higher. This requirement would apply to any specialist registered following its adoption and to specialists and joint accounts now registered within a reasonable time after it is adopted.

The S.E.C. staff report observes that there are no competing books on the Exchange. The Committee feels that every specialist should compete satisfactorily with standards of performance. The Exchange should not hesitate, however, to approve competing books when it appears that competition may improve the market in the stocks involved, and that the specialist who wishes to compete is qualified and adequately financed.

The question of alternate specialists should also be considered by the Exchange. If a specialist leaves his post, he must turn over his orders to another specialist. The Exchange should be certain that one or more alternate specialists are available in each case.

Allocation of Securities to Specialists

The Committee on Floor Transactions now allocates stocks to specialists. Allocation has been done on a basis which does not always reflect a careful analysis of the past performance of the specialist.

Since September 1, 1961, the policy of the Exchange has been to assign newly listed issues to specialists "in the best interest of the Exchange." The Committee on Floor Transactions considers such matters as the financial ability of the specialist, his general performance in handling his duties, the relative activity of the stocks in which he specializes and the length of time which has elapsed since a new listing was allocated to him.

Although the current method of allocation is an improvement over former methods, it is still inadequate. The broad policy behind any allocation method should be "the best interest of the public". The Exchange should measure the past performance of specialists to determine which ones are best qualified to make a fair and orderly market in the new listing. The type of stock, the floating supply, and the price level, should also be considered. There should be statistical analyses for stated periods of specialists' daily carry-over positions, the percentage of their trades which are stabilizing, the continuity of their markets, the percentage of trades done by the specialists for their own accounts and the spreads in the quoted market.

A specialist should be informed of impending new listings and be permitted to request that a new listing be allocated to him. The staff should produce the necessary statistical analyses for all specialists who apply and the Floor Governors should interview applicants and make recommendations for allocations to the Steering Committee. The Steering Committee should not make the final judgment, but should make a specific recommendation to the Board of Governors in each case. The final determination should be made by the full Board.

Communication between Specialists and Corporate Management

The Committee believes that a specialist is entitled to keep himself informed concerning the earnings and business outlook for the companies in whose stocks he specializes to the same extent as a well-informed security analyst.

Rule 191(a) of the Exchange, effective May 19, 1961, prohibits a specialist from effecting business transactions with a company, or officers or directors of a company, in whose stock he is registered. The rule is interpreted by the Exchange to bar the specialist from acting as a broker for the company, its officers or directors. It is recommended that the rule be extended to cover principal stockholders of the company and be strictly enforced.

If this is done, there will be little if any likelihood of abuse through communications between specialists and corporate management. This rule is not intended to prohibit the specialist from acting as a broker's broker in the ordinary course of his business.

Public Customers of Specialists

The S.E.C. staff report points out that certain specialists on the Exchange are members of firms which do a public business. Proper safeguards should be enforced to assure that customers of such firms do not receive preferential treatment by specialists and that specialists do not misuse public accounts.

Rule 190(b) of the Exchange requires the specialist to report all accounts introduced by him to member firms and to state whether he has a beneficial interest in such accounts. This rule is sound, but should be supplemented by a further rule requiring the specialist to report immediately all transactions he executes for public customers on the Exchange in stocks in which he is registered except as a broker's broker.

It appears that certain specialists may have used the market mechanism to distribute unregistered stock. Any such occurrence must be dealt with severely. Individual, allied, and associate members should be extremely diligent in checking any order which raises questions of this nature.

Long Term Investment Accounts

Specialists sometimes designate securities they have purchased to be held in long term investment accounts. In doing so, they are subject to the provisions of rule 174 of the Exchange which reads as follows:

> "No specialist shall effect on the Exchange purchases or sales of any security in which such specialist is registered, for any account in which he, his member firm or any partner thereof or his member corporation or any stockholder therein, is directly or indirectly interested, unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market, or to act as an odd-lot dealer, in such security."

Since it is the clear intent of rule 174 to limit the transactions of a specialist to those which are necessary to maintain a fair and orderly market, it follows that an investment position in such securities can only result from such stabilizing transactions. Additionally, it is clear that any investment position must be available to the market when needed.

It is therefore recommended that the Exchange enforce a policy that a specialist, under the terms of rule 174, may not go into the market with the intention of effecting purchases for a long term investment account in stocks in which he is registered, that his long term account should be no more than a small fraction of the floating supply, and that it should have no effect on his primary duty of maintaining a fair and orderly market. This means that the specialist should be ready to sell securities from any such long term investment account, or sell short in his trading account to the extent necessary to satisfy his obligation as a specialist. Any changes in specialists' long term investment accounts should be reported to the Exchange and carefully analyzed.

Handling of Odd-Lot Orders

Since specialists on the Exchange act as odd-lot dealers in the securities in which they are registered, odd-lot orders are filled from their own accounts. The price is determined by the price of the next succeeding round-lot sale and the specialist is compensated by receiving a specific price differential based on the round-lot price per share.

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Although this system seems to have worked well, it emphasizes the fact that all specialists must be aware of their fiduciary obligation to act affirmatively. For example, without approval of Floor Governors, no specialist should be allowed to withdraw his bid or offer when he receives an odd-lot order on the opposite side of the market. Moreover, the specialist must accept his responsibility to buy or sell stock at a proper price and to satisfy supply or demand even though he may be asked to buy or sell odd-lots of the same stock at the same time.

Exchange rules forbid a specialist or other member to "stop" a stock on a spread of one-eighth of a point between the bid and offer. While this rule may seem unfair at times because of the specialist's obligation to handle both round-lot and odd-lot orders, it is a sound rule and should be strictly enforced.

Disclosure of Specialist's Book in Secondary Distributions

Section 11(b) of the Securities Exchange Act of 1934 makes it unlawful:

> ". . . for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist. . . ."

Rule 173 of the Exchange reflects the intent of Section 11(b) by forbidding a specialist to disclose information with regard to orders entrusted to him as specialist to any person other than a member of the Committee on Floor Transactions.

As a matter of practice, the Exchange requires the distributor of a security in a secondary distribution to make available (through the specialist) a sufficient amount of stock to fill all bids held by a specialist at a price equal to or above the offering price. This practice protects investors who have placed bids through the auction process prior to a secondary. Moreover, the practice does not appear inconsistent with the intent of Section 11(b) since the disclosure occurs after the secondary is effective and is for the sole purpose of making a bona fide offer to public investors whose buy orders at or above the offering price are on the specialist's book. The difficulty is that the practice requires a limited disclosure and there is no stated basis on which the disclosure is to be made.

A clear statement of the proper procedure should be adopted by the Exchange as a guide. Underwriters should not approach specialists to obtain the information they need, either in advance of the secondary or when it becomes effective, but should approach designated Exchange officials. A procedure should be developed which would not violate the intent of Section 11(b), but would preserve the protection to investors contemplated by the current practice.

Reporting by Specialists

In recent months, the Exchange has supplemented its reporting requirements for specialists in such a way that they are burdened each day with extensive clerical work creating a mass of statistical data which is difficult to analyze. While daily reports under rule 191 contain the information needed as a basis for proper surveillance of specialists' activities, they cannot be studied systematically. Moreover, there is a duplication of reporting through the daily clearance report and the ST form used when there is unusual activity in a stock.

The trading of specialists should be analyzed in a surprise "spot" check for periods of two weeks or more at least four times each year. If there is any indication of irregularity in the market for a particular stock on a given day, the appropriate records should be requested from the specialist.

Specialists' reports should show as a running record, for each stock over a given period of time, the trade date, the time of the transaction, the number of shares bought, the number of shares sold and whether long or short, the price, the "tick" and the position at the opening each day. Odd-lot transactions should be indicated separately and not as part of the aggregate figures. The Exchange could supply forms for this purpose or require specialists to keep loose-leaf books from which pages could be removed and photocopied. Copies could be made available by specialists to their clearing agents as a regular matter.

It is recommended that the Exchange study the possibility of a single reporting form or a revised, uniform trading account book.

Mechanical and Personnel Requirements on Floor

It is recommended that the Exchange study possible improvements in the physical arrangement of the floor, and consider whether personnel is adequate and properly utilized. It appears that improvements can be made which would serve the public by increasing speed and efficiency, minimizing chances for error and improving ticker and other reporting services:

(1) *Trading Posts:* The areas behind the trading posts are too cramped to allow Exchange employees and specialists' clerks to stand inside the posts. It is necessary for clerks to stand beside specialists, a practice which can create some confusion in active markets. It might be possible to redesign the posts to accommodate the necessary personnel.

(2) *Booth Space for Member Organizations:* The booths are on graduated platforms on two sides of the Exchange floor. The efficiency of this type of booth should be studied. If it could be worked out within space limitations, a system which would reduce the physical strain on those whose booths are on the upper tiers might be preferable.

(3) *Pneumatic Tubes:* The tube system is not fully efficient. Orders taken by tube boys from the booths of member organizations are placed in carriers and sent through a double tube system to a room beneath the trading floor. The orders are then removed, examined by Exchange employees and redirected to the correct trading posts. It should be possible to substitute a direct booth-to-post system which would save time and eliminate the double handling of orders.

(4) *News Service:* Because it gives an advantage to members on the floor over the public, the Dow-Jones news service, installed at either end of the floor, should be removed.

(5) *Communications:* Consideration should be given to allowing specialists to have telephones from their posts to their offices to facilitate clearing up open trades. Such telephones should not be used for the transmission of orders.

(6) *Floor Information:* Ex-dividend notices should be posted on a regular basis. A better system should be devised for posting last sales, showing whether they are on up-ticks or down-ticks. In active markets, specialists are not always able to make the by-hand changes now required. Consideration should also be given to a tape delay meter to be displayed prominently on the floor.

(7) *Units of Trading:* The basic unit of trading is 100 shares, but the Exchange also designates certain stocks for 50, 25 and 10 share units. A study of this practice might indicate that there should be only one other unit, perhaps a 10 share unit.

(8) *Exchange Personnel:* There are now some 60 Exchange employees on the floor. A modest increase in floor supervisors—perhaps four added employees—might improve operations considerably. In addition to the use of hand signals, the Exchange might consider the use of a limited number of squad boys to help the flow of orders and reports in active markets.

(9) *Reporting Executed Orders:* When a sale takes place, the reporter notes the transaction on a slip of paper to be handed to an Exchange employee who sends it through the tube system to the ticker area. The reporter must also flip his pad and make a second notation in his list showing all trades in the stock for the day. In active markets the process is slow and reports are delayed in reaching the ticker area. The problem could be solved by having the day's sales noted from the ticker by personnel stationed away from the trading posts.

Elimination of Associate Memberships

The Exchange now has 499 regular members and 415 associate members, comprising 611 member organizations. Its entire membership, including partners, stockholders and registered representatives of member organizations, shares a responsibility to see that proper standards of conduct prescribed are adhered to without fail. All members and member organizations sharing in the benefits of the Exchange and subject to its regulatory jurisdiction should assume the obligations of full membership, have the right to vote, and become active in Exchange management.

The Committee has recommended in its first interim report that no new associate members be admitted and has considered the feasibility of a procedure to enable existing associate members to become regular members on a basis which would be fair and equitable both to them and to existing regular members. It has studied the probable economic and tax consequences of two plans in particular. Under the first, appropriate fractional interests in newly created regular memberships would be distributed to all regular members and could be purchased by qualified associate members for a limited period. Under the second, each qualified associate member would have the right to purchase a regular membership from the Exchange at a stated price for a limited period.

It is recommended that the Board of Governors appoint a special committee to submit a plan under which associate memberships would be eliminated within a period of 18 months. This Committee would be glad to make its own studies available to such a special committee.

Stock Clearing Corporation

Both the American Stock Exchange and the New York Stock Exchange operate stock clearing corporations for use by clearing members of the respective exchanges in settling transactions. The functions of the two clearing corporations are substantially identical and only 12 members of the American Stock Clearing Corporation are not members of the New York Stock Clearing Corporation.

The possibility of merging the operations of the two clearing corporations has been discussed for many years. It is the consensus of member firm management that such a step would result in increased economy and efficiency.

Although the Committee is not primarily concerned with operating problems of the Exchange community which do not have a direct bearing on the public, it feels that any improvement in overall efficiency is bound to improve the Exchange's effectiveness in its dealings with the public. Accordingly, it is recommended that the American Stock Exchange seek the cooperation of the New York Stock Exchange in a study of the feasibility of merging the operations of the two clearing corporations into a single facility to serve the clearing members of both exchanges.

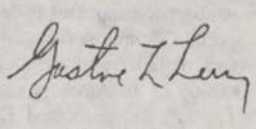
Period of Transition

The Board of Governors has approved in principle the proposed changes in the organization and administration of the Exchange. It has appointed one committee to prepare proposals to implement this Committee's first interim report and another committee to recommend a new President.

The Committee recognizes that there will be a somewhat complicated transition period when the reorganization proposals are adopted, and that the new President will have a major task in securing and organizing an adequate staff.

The Exchange has already taken important steps to assure that its operations are conducted in a way which reflects its public trust. It should expect the cooperation of all members and member firms to carry out the tasks which lie ahead.

Respectfully submitted,



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[EXHIBIT B]

Memorandum concerning the proposed General Amendment of the Constitution of the American Stock Exchange.

The General Amendment of the Constitution of the American Stock Exchange being submitted to the regular members for approval is designed to carry out various recommendations in the first report of the Special Committee for Study of the American Stock Exchange as approved in principle by the Board of Governors on December 27, 1961. The Amendment has been prepared under the direction of an Advisory Committee of the Board of Governors appointed on December 29, 1961. The Securities and Exchange Commission has also taken an active interest in the matter and has suggested or requested certain of the revisions made in the Amendment.

The principal changes embodied in the General Amendment are (a) a change in the composition of the Board of Governors to reflect on a balanced basis the diversity of business interests of the membership, and (b) a change in the management structure, through elimination of the present standing committees. The end result will be to reserve policy matters for the full Board of Governors and lodge responsibility for operations and management in the President and Staff.

1. The composition of the Board is changed to consist of:

   (a) Twelve governors who must be regular members of the Exchange having their principal place of business in or within 100 miles of New York City. At least ten of them shall spend a substantial part of their time on the Floor of the Exchange. At least six of them must be general partners or voting stockholders of regular member firms or regular member corporations doing business with the public and having no general partner or voting stockholder therein who is a specialist on the Exchange.

   (b) Ten governors who are principally engaged in office functions and have their principal place of business in or within 100 miles of New York City, and who are regular, allied or associate member partners or voting stockholders of member firms or member corporations or non-member general partners of associate member firms or associate member directors or executive officers in associate member corporations, doing business with the public and having no general partner or voting stockholder therein as a specialist on the Exchange.

   (c) Five governors of the qualifications described in the preceding subparagraph (b), except that they must have their principal place of business more than 100 miles from New York City.

   (d) The Chairman of the Board, the President of the Exchange and three public governors. [See Article II, Section 1(a).]

2. In view of the change in the composition of the Board, a special election is to be held within 45 days following the approval of the General Amendment. This date will be promptly fixed by the present Board after the General Amendment is approved.

At such special election a Chairman of the Board, nine governors, two Trustees of the Gratuity Fund and a Nominating Committee of seven members are to be elected to serve until the annual election of the Exchange in February 1963. Nine governors and two Trustees of the Gratuity Fund are to be elected to serve until the annual election in February 1964. Nine governors and one Trustee of the Gratuity Fund are to be elected to serve until the annual election in February 1965.

If they are eligible under the new composition of the Board, persons now serving on the Board are eligible for election at the special election and at any subsequent annual election provided that the period of consecutive service both before and after September 4, 1962, is not to exceed three years in the case of the Chairman of the Board and six years in the case of a governor other than the Chairman. Candidates for the special election will be nominated by the nominating committee which selected the slate of candidates for the election held last February 12th. Candidates may also be nominated by independent petition signed by 25 regular members.

It is expected that the new Board will take office on September 4, 1962. At the annual elections in 1963 and thereafter governors coming within the classifications mentioned in (a), (b) and (c) of paragraph 1 above are to be elected for three year terms. [See Article III, particularly Sections 1 and 11.]

3. At the special election and at each annual election the regular members are to elect a Nominating Committee of seven members to serve until the next annual election. The Committee is to consist of: (a) four regular members, of whom not more than two are specialists on the Exchange or in regular member organizations having a general partner or voting stockholder therein who is a specialist on the Exchange; and (b) three allied or associate members of regular or associate member organizations or non-member general partners or voting stockholders of associate member organizations, which do business with the public and have no general partner or voting stockholder therein who is a specialist on the Exchange.

The Board of Governors is to have no control over or power with respect to the Nominating Committee. In addition to nominations by the Nominating Committee, independent nominations may be made for all or less than all of the positions to be filled at the election. [See Article III, particularly Sections 6 and 11.]

4. Provision has been made for limiting the period of consecutive terms on the Board of Governors. A member who has been elected as Chairman of the Board for three consecutive terms is not eligible for election as Chairman except after an interval of three years or for election as a governor except after an interval of two years. No other elected governor who has served part or all of two consecutive terms is eligible for election as a governor, other than as Chairman, except after an interval of two years. [See Article III, Section 3.] Under the present Constitution there is no limitation with respect to the Chairman, and other elected governors after serving two consecutive terms are again eligible for election after an interval of one year.

5. The present system of nine Standing Committees is abolished by the General Amendment. The policy-making functions of those committees will be handled directly by the Board, and the administrative functions performed by those committees will be handled by the President and the staff officials of the Exchange. The General Amendment more clearly defines the administrative responsibility of the President as the chief executive officer of the Exchange. The Constitution empowers the Board to delegate necessary powers to the President or other officers or employees of the Exchange, or to committees, but policy matters will be reserved for determination by the Board. [See Article II, Section 1(b) and Section 2.]

6. The General Amendment creates an Advisory Committee to be composed of seven governors having their principal place of business in or within 100 miles of New York City. Four members of this committee are to be regular member governors who spend a substantial part of their time on the Floor of the Exchange, at least two of whom are to be general partners

or voting stockholders of regular member firms or corporations which do business with the public and have no general partner or voting stockholder therein as a specialist on the Exchange. Three members of this committee are to be governors principally engaged in office functions in regular or associate member firms or corporations which do business with the public and have no general partner or voting stockholder therein as a specialist on the Exchange.

The members are to serve on a rotating basis, with no member serving for more than four consecutive months. The Advisory Committee is to consult with and assist the President and staff of the Exchange in the administration and interpretation of the provisions of the Constitution, the rules of the Exchange and the policies promulgated by the Board.

The Advisory Committee is to review any decision of an officer or employee of the Exchange, either at the request of any member, member firm or member corporation affected by such decision or at the request of the President, and in such case the Advisory Committee, if it does not approve the staff decision, is to refer the matter to the Board for its determination. The Board may delegate to the Advisory Committee such other powers as the Board may from time to time determine, including the power to impose fines within such limits as may be prescribed by the Board but not in excess of $500 for each offense. [See Article II, Section 3(a), and Article V, Section 2(a).]

7. A member affected by a decision of the Advisory Committee or by a decision of the Exchange staff or of a committee acting under delegated powers, may take an appeal from such decision directly to the Board by filing a written demand therefor with the Secretary of the Exchange within five business days. [See Article II, Section 1(b).]

8. In connection with admission to regular membership, the present Constitution requires the approval of the Board by the affirmative vote of nineteen governors. The General Amendment provides that such approval may be by the affirmative vote of two-thirds of the governors present at a meeting of the Board, except that nineteen affirmative votes are required for readmission to membership of a person who has been suspended or expelled or declared ineligible for reinstatement. Election of an associate member also requires the affirmative vote of two-thirds of the governors present at a board meeting. [See Article IV, Section 1(a) and (c).]

9. Under the present Constitution, various approvals are required to be obtained from one of the Standing Committees such as the Committee on Admissions or the Committee on Outside Supervision, etc. Under the General Amendment these functions will be performed either directly by the Board of Governors or by officials to whom the power has been delegated. The General Amendment reflects this change in the various places where it is applicable.

10. In Article V dealing with disciplinary matters, various changes have been made in the procedure and requirements. Investigation of conduct will be the responsibility of the staff, but disciplinary decisions will be made by the Board or, in limited areas, by the Advisory Committee.

Certain procedural changes in disciplinary trials have been made in Section 1(b) of Article V. In Section 1(c) the power to fine has been increased to a maximum of $5,000 in the case of disciplinary matters dealt with in summary procedure by the Board. Under Section 2(a), the Board may delegate disciplinary power to the Advisory Committee, including the power to impose fines not in excess of $500 for each offense, but the Advisory Committee is not to have any power to suspend or expel a member.

Under Section 4(a) of Article V, the general requirement in disciplinary trials is that seventeen governors are required to constitute a quorum, the affirmative vote of nineteen governors is required to impose the penalty of expulsion, and the affirmative vote of a majority, but not less than twelve, of the governors present at the meeting is required for the penalty of suspension or fine. Under Section 4(1), for each offense charged against a member in respect of which the Board may impose a penalty of suspension or expulsion, the Board may, in addition to or in lieu of such penalty, impose a maximum fine of $10,000 or such other penalty as the Board may deem appropriate.

11. Under Article VIII the administrative powers previously exercised by the Committee on Arbitration are now generally to be vested in an arbitration director who is appointed by the President of the Exchange, subject to the approval of the Board of Governors. The panel of arbitrators will be selected with the approval of the Board.

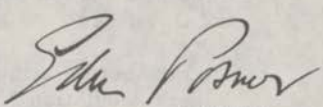
12. Provision is made in Article XII for vesting the powers of the Board of Governors in an Emergency Committee in the event of an enemy attack involving substantial damage or injury in the United States such as through atomic, radiological, chemical, etc., warfare.

13. Under Article XIV of the General Amendment, it is provided that Article III relating to elections, including the special election mentioned above, is to become effective as of the last day of the period for voting on the Amendment by the regular members, and all other provisions of the General Amendment are to become effective on September 4, 1962.

14. The General Amendment is not designed to change the present status of associate members. The matter of associate membership is under study, but any change in this respect would necessitate a subsequent amendment with the approval of the required vote of regular members.

The foregoing summary of the principal changes made by the General Amendment is not intended to enumerate or discuss in detail all the changes embodied in the Amendment. Regular members are requested to study carefully the various provisions of the General Amendment, which is submitted herewith for their consideration and approval.

BOARD OF GOVERNORS,

By: 

Chairman.

June 9, 1962.

[EXHIBIT C]

AMERICAN STOCK EXCHANGE

Proposed Resolutions Delegating Authority to President and Approving His Redelegation to Other Officers and Employees

September 6, 1962

RESOLVED, That, effective September 6, 1962, the Board of Governors delegates to the President of the Exchange, and his successors in office, with authority to redelegate to the persons from time to time occupying such other offices and positions as he may from time to time determine, power to act on behalf of the Board of Governors for and in the name of the Exchange with respect to:

I. The administration of the Constitution and the Rules of the Board of Governors adopted pursuant thereto, and the carrying out of the policies of the Board, and

II. Specifically, but without thereby limiting the generality of the foregoing,

a. to take or to refrain from taking any action which the Exchange may take or refrain from taking under any Rule of the Board of Governors;

b. to issue directions with respect to Exchange contracts, as provided for in the Rules of the Board of Governors;

c. to take action with respect to any matter as to which Regulation T of the Federal Reserve Board (as the same may exist from time to time) requires or makes provision for action or approval by a national securities exchange or by a regularly constituted appropriate committee thereof;

d. to approve applications for the listing and registration of securities in the following categories and the admission of such securities to dealings on the Exchange on an "issued", "when issued" or "when distributed" basis:

(1) direct obligations of or obligations guaranteed as to principal or interest by the United States, or any State or political sub-division thereof;

(2) direct obligations of any agency or instrumentality of the United States, or of any State or political sub-division thereof;

(3) securities of an issuer having securities already listed on the Exchange;

(4) certificates of deposit, rights to subscribe, and other securities issued in exchange for or growing out of securities already listed on the Exchange.

e. to suspend dealings in or remove from listing and registration securities in the following categories:

(1) matured or redeemed securities, including securities which have come to evidence merely the right to receive cash or other securities;

(2) securities in substitution for which other securities are being listed or admitted to unlisted trading;

(3) securities of which the amount outstanding, after deducting any concentrated holdings by the issuer and/or by other persons or corporations has been so reduced as to make further dealings on the Exchange inadvisable, in the opinion of the President or of any person to whom authority to act with respect thereto may have been delegated;

(4) securities as to which notice, deemed to be authoritative by the President or by any person to whom authority to act with respect thereto may have been delegated, has been received that they are without value;

(5) securities as to which registration or exemption pursuant to the Securities Exchange Act of 1934 is no longer effective.

f. to certify to the Securities and Exchange Commission the approval of the Exchange of the listing and registration of securities and to execute and file with the Commission applications on behalf of the Exchange for the removal of securities from listing and registration;

g. to fix, either in general or in specific cases, the fees and charges for the use of the facilities and services of the Exchange, including fees charged to issuers for the listing of securities on the Exchange.

h. in accordance with Section 6 of Article IV of the Constitution, to permit, in the event of the death of the sole Exchange member of a member firm or member corporation, under such conditions as he may fix, the then existing other partners in the partnership or other stockholders in the corporation to continue the status of a member firm or member corporation, as the case may be, for a period not to exceed sixty days from the date of death of the deceased member and to withdraw such permission;

i. in accordance with Section 1(c) of Article IV of the Constitution, to permit, in the event of the death of the sole associate member of an associate member firm or associate member corporation, under such conditions as he may fix, the then existing other partners in the partnership or other stockholders in the corporation to continue the status of an associate member firm or member corporation for a period not to exceed thirty days from the date of death of the deceased associate member and to withdraw such permission; and

j. to take any action provided to be taken by the Exchange by any requirement of law or by any rule or regulation of any Federal, State or Municipal authority.

RESOLVED, That the Redelegation of Authority dated September 6, 1962, by the President to the persons from time to time occupying the offices and positions therein designated be approved and the delegations therein set forth be adopted as delegations by the Board to the persons from time to time occupying such offices and positions, with power in the President to suspend or terminate from time to time, any one or more of such delegations in whole or in part.

[EXHIBIT D]

AMERICAN STOCK EXCHANGE

86 TRINITY PLACE

NEW YORK 6, N. Y.

April 1, 1963

To the Regular Members of the
AMERICAN STOCK EXCHANGE

The Board of Governors has unanimously adopted the attached amendments of the Constitution as part of a program to settle the 15-month debate concerning the status of associate membership.

The plan is designed to make regular membership more attractive and to re-open, rather than eliminate, the associate membership category. Up to 101 new seats could be issued this year and 50 more seats would be authorized for issuance if Exchange business is strong. If all seats were sold, at least $9,068 would be distributed to each current member and the equity of each member of the Exchange would be maintained. There would be a moderate increase in commissions paid by associate members.

These features and other details are summarized in the following statement. The immediate goal of the program is to attract volume to the Exchange without diluting the business of members now active on the Floor. The long-range goal is to position the Exchange to help pace the growth of the securities industry.

Late in 1961, the Special Committee for Study of the American Stock Exchange concluded that associate memberships should be terminated principally because they enjoy disproportionate financial advantages over regular members. Pending a review of this recommendation, which could have involved the issuance of nearly 400 new seats, the Board halted the admission of new associate member organizations.

A committee of Governors, with the cooperation of many interested members, has studied alternatives since last September. It has concluded that the elimination of associate memberships would not be advisable, but that the Exchange should take a positive step to attract qualified firms, most of them located out of the New York area, to the regular membership. The active support of these major firms will help the Exchange achieve its full potential for business and attract solid growth companies to list.

The committee has developed a balanced, affirmative program—good for the Exchange and the public, fair to regular and associate members. One of its major conclusions is that no more than 18 of the 101 firms most likely to buy seats would consider placing their own brokers on the Floor and that only 5 of the next 50 would consider doing so. The committee also noted that many firms which might want direct Floor representation would undoubtedly consider inviting present independent members to join their firms.

The program will become effective if a majority of the regular members cast their votes within two weeks and if a majority of those voting approve the amendments. Ballots and return envelopes are enclosed together with the amendments.

Regular members are the custodians of the Exchange's future. This program is a constructive step which will enable the Exchange to realize its full potential in a promising future. At the same time, it meets the Exchange's immediate needs and will be of direct benefit to all members. The full Board of Governors believes it deserves your enthusiastic support.

Sincerely yours,

Edwin D. Etherington
President

Ellis Peters
Chairman of the Board

AMERICAN STOCK EXCHANGE

Summary of Program and Constitutional Amendments Relating to Associate Membership

(1) Associate membership would be made available immediately to qualified representatives of approved partnerships and corporations, but not to individuals. Those who want to be active as individuals would have to apply for regular membership.

(2) New associate members would pay an initiation fee of 5% of the last sale price of a regular membership, but not less than $1,000, and annual dues equal to regular members dues. This lower initiation fee would attract business from firms which meet admissions standards but do not have the capital to invest in full memberships. They could transfer the membership within their organizations under the same conditions now prescribed, with a minimum of cost or inconvenience.

(3) Effective July 26, 1963, the give-up rate (Floor brokerage) of commissions payable by associate members would be increased by one-fifth and the clearance rate would be increased by one-seventh.

Regular members pay 20% of commissions to cover the give-up rate and 30% to cover combined give-up and clearance charges. Associate members now pay only 5 percentage points more. Payments by associate members would be increased to 30% to cover the give-up rate and 40% to cover the combined rate. The greater spread of 10 percentage points between these and regular member rates would provide incentive to buy regular memberships.

(4) Up to 101 new seats would be sold to present associate members (or their general partners or directors holding voting stock) at the last completed sale price in the regular seat market less a discount of $5,000, but for a price not less than $40,000. If the seat market should drop below $45,000, anyone purchasing a new seat at the minimum $40,000 price would receive less than the $5,000 discount.

After December 31, 1963, none of the 101 seats would be sold at less than $55,000 as described in the next paragraph.

(5) Up to 50 more seats would be authorized for sale no later than December 31, 1965, at a minimum price of $55,000. If the last sale in the regular seat market were $60,000 or higher, the full $5,000 discount would apply. These seats and any of the initial 101 not sold would be available for further expansion in the next two years in the event of improved Exchange business and resulting improvement in the regular seat market.

All new seats would be sold to present associate members on a first come, first served basis.

(6) Current regular members would receive through quarterly payments all amounts from the proceeds of sale above $15,000 per seat. If all authorized seats were sold at minimum prices this would result in a distribution of $9,068 per member. The amount would be higher if the average seat price exceeds the minimum.

Sale of new seats under the formula described above, would result in the following:

Seat Sales	Proceeds	Amount Paid to the Exchange	Amount Paid to Each of 499 Members	
			Aggregate	Per Member
Sell 101 Seats at $40,000	$4,040,000	$1,515,000	$2,525,000	$5,060
Sell 50 Seats at $55,000	2,750,000	750,000	2,000,000	4,008
Total	$6,790,000	$2,265,000	$4,525,000	$9,068

If all seats sold at an average price of $50,000—a realistic possibility—each member would receive $10,591.

In addition to cash distributions to members, this approach would also serve to maintain each member's present equity of about $15,000 which would be added to Exchange funds following each sale. This procedure avoids diluting the equity of current members and will place the Exchange in a position to take advantage of technological advances and improve its facilities and services as required by increased volume without assessing the membership excessively.

The Board has concluded that the additional capital is necessary—not for current Exchange expenditures — but as a reserve to meet predictable needs of the future. In addition it is felt that associate members should be assured that part of the money they invest in a seat will be used to strengthen the Exchange as an institution.

(7) The initiation fee for existing associate members who buy regular memberships, whether from the new seats issued or in the regular seat market at any time, would be waived. (The fee paid by associate members is credited against the regular membership fee under the existing Constitution.) The fee for those who became associate members after adoption of the plan, and later bought regular memberships, would not be waived.

The waiver of the initiation fee and the proposed $5,000 discount would be necessary inducements to associate members to acquire regular memberships, and would be fair recognition of their contributions to the Exchange. The waived initiation fee would also be a continuing inducement to well over 200 firms (associate members who do not buy new seats) to enter the regular seat market at some time in the future after the new seats are sold.

(8) The Constitution and Rules would be reviewed to bring partners and co-stockholders of associate member organizations, as nearly as possible, under the same control and subject to the same discipline, as regular members. Admissions standards would be enforced rigidly.

(9) The entire program, except for the increase in the commission rates payable by associate members, would become effective the first business day following approval of the amendments of the Constitution. The commission rates would remain unchanged until July 26, 1963, to give associate members a reasonable time to make their decisions.

AMERICAN STOCK EXCHANGE

86 TRINITY PLACE

NEW YORK 6, N. Y.

April 1, 1963.

TO THE REGULAR MEMBERS:

The Board of Governors on March 28, 1963, adopted the following amendments to the Constitution which, to become effective, must be approved by a majority of the votes cast by a majority of the Regular Members entitled to vote:

Amend the first paragraph of subsection (a) of Section 1 of Article IV of the Constitution to read as follows:

Number of regular memberships

Sec. 1.(a)(1) Regular membership—The regular memberships shall consist of 499 regular memberships together with such additional regular memberships as may be purchased pursuant to the provisions of subdivision (4) of this Section 1(a); provided, however, that the total regular memberships shall be reduced to such smaller number as may result from the retirement of regular memberships pursuant to the provisions of Section 7 of this Article. The number of regular memberships may be increased or decreased by an amendment of the Constitution.

Amend the second paragraph of subsection (a) of Section 1 of Article IV of the Constitution by inserting at the beginning of said second paragraph the designation "(2)".

Amend the third paragraph of subsection (a) of Section 1 of Article IV of the Constitution by inserting at the beginning of said third paragraph the designation "(3)".

Amend subsection (a) of Section 1 of Article IV of the Constitution by inserting at the end of said subsection (a) a new paragraph as subdivision (4) thereof to read as follows:

Acquisition of limited number of additional regular memberships by certain associate members

(4) Subject to the conditions hereinafter in this subdivision (4) specified, the Exchange shall offer additional regular memberships for sale, within the limitations and at the prices hereinafter set forth, to those persons electing to purchase a regular membership pursuant to this subdivision (4) who are either associate members on the effective date of this amendment and continue to be such down to the date of such purchase or are general partners of or directors holding voting stock in firms or corporations which were associate member firms or corporations on the effective date of this amendment and continue to be associate member firms or corporations down to the date of such purchase, and who also meet the requirements for admission to regular membership and are approved by the Board of Governors in accordance with the provisions of the Constitution and the rules and requirements of the Exchange. The purchase price of such additional regular memberships shall be determined as follows:

(A) Until such time as a total of 101 additional regular memberships have been sold pursuant to this subdivision (4), but not later than December 31, 1963, each such associate member, partner or director who applies for regular membership and elects to purchase such regular membership pursuant to this

subdivision (4) shall pay to the Exchange therefor a sum equal to whichever is the higher of the following two amounts, namely: (i) an amount equal to the latest price at which a regular membership shall have been sold and transferred to an applicant for regular membership, otherwise than for a nominal consideration or through a private sale or pursuant to this subdivision (4), prior to the date of such purchase pursuant to this subdivision (4), less the sum of $5,000; or (ii) $40,000.

(B) After a total of 101 additional regular memberships have been sold pursuant to subparagraph (A) above, or after the expiration of the period ending on December 31, 1963, whichever of such two events shall occur first, but not later than December 31, 1965, each such associate member, partner or director who applies for regular membership and elects to purchase such regular membership pursuant to this subdivision (4) shall pay to the Exchange therefor a sum equal to whichever is the higher of the following two amounts, namely: (i) an amount equal to the latest price at which a regular membership shall have been sold and transferred to an applicant for regular membership, otherwise than for a nominal consideration or through a private sale or pursuant to this subdivision (4), prior to the date of such purchase pursuant to this subdivision (4), less the sum of $5,000; or (ii) $55,000.

The total of the additional regular memberships sold pursuant to subparagraphs (A) and (B) above shall not exceed 151 regular memberships. No regular memberships shall be sold pursuant to this subdivision (4) after December 31, 1965. Payment to the Exchange of the purchase price provided for above shall become due and be payable on the date on which the application for regular membership is considered by the Board of Governors, and prior to such consideration. In the event that two or more persons notify the Exchange at the same time of their election to purchase a regular membership pursuant to this subdivision (4) and an insufficient number of regular memberships remain available for purchase at that time pursuant to this subdivision (4), then priority shall be given to such applicant or applicants as have, or whose member firms or corporations have, been associate members or associate member firms or corporations for the longest period.

Out of the proceeds received by the Exchange from each sale of a regular membership pursuant to this subdivision (4) the sum of $15,000 shall be retained by the Exchange, and the balance of the proceeds from such sale of a regular membership shall be distributed by the Exchange in equal shares to the 499 persons who are regular members of the Exchange on the effective date of this amendment (including in the case of any such regular member who is deceased, the estate of such regular member). Such distributions shall be made quarter-annually commencing on July 1, 1963.

Amend the first paragraph of subsection (c) of Section 1 of Article IV of the Constitution to read as follows:

(c) Associate membership—The number of associate members shall be such as may be determined by the Board of Governors from time to time. The affirmative vote of two-thirds of the governors present at a meeting of the Board shall be necessary to elect a person to associate membership. Any person not less than twenty-one years of age who is actively engaged in the business of buying and selling securities as broker or dealer, either as a partner of a firm or as a director or executive officer of a corporation may make application for associate membership. Any person elected to associate membership prior to the effective date of this amendment, as an individual or as a partner of a firm shall remain an associate member only so long as he is actively engaged in the business of buying and selling securities as broker or dealer. Any person elected to associate membership after the effective date of this amendment, as a partner of a firm shall remain an associate member only so long as he remains a partner of such firm or of another firm continuing the business of the first firm or a director or executive officer of a corporation continuing the business of the first firm. Any person elected to associate membership, whether before or after the effective date of this amendment, as a director or executive officer of a corporation shall remain an associate member only so long as he remains a director or executive officer of such corporation or of another corporation continuing the business of the first corporation. An associate member and the member firm or member corporation of which he is a partner or a director or executive officer shall have such rights and privileges as may, from time to time, be prescribed by the Board of Governors. An associate member and the member firm or member corporation of which he is a partner or director or executive officer shall at all times be subject to the provisions of the Constitution and the rules and policies of the Exchange.

Amend subsection (b) of Section 2 of Article VI of the Constitution to read as follows:

(b) The Minimum Commission Rates to Regular and Associate Members on Stocks, Rights and Warrants (hereinafter referred to as Stocks) shall be as follows:

Selling	Rate per 100 shares — Regular Members — Give-up	Regular Members — Clearance	Associate Members — Give-up	Associate Members — Clearance
at 1/256 of $1	$ .03	$ .05	$ .04	$ .06
at 1/128 of $1	.05	.08	.06	.09
at 1/64 of $1 and under 2/32 of $1	.17	.25	.20	.29
at 2/32 of $1	.17	.25	.20	.29
over 2/32 of $1 and under 8/32 of $1	.33	.50	.40	.57
at 8/32 of $1 and under ½ of $1	.55	.85	.65	.97
at ½ of $1 and under $1	1.00	1.50	1.20	1.70
at $1 and under $2	1.75	2.75	2.40	3.45
at $2 and under $5	2.05	3.20	2.80	4.00
at $5 and under $10	3.30	4.90	4.85	6.30
at $10 and under $20	4.00	6.05	6.35	8.20
at $20 and under $40	5.10	7.75	8.05	10.75
at $40 and under $100	5.65	8.60	8.90	11.80
at $100 and above	6.50	9.75	21.35	24.85

Notwithstanding the foregoing rates, the minimum commission to Regular and Associate members shall be not less than $1 per single transaction, unless the amount involved in such transaction is less than $10, in which event the commission may be as mutually agreed.

Amend the first two paragraphs of subsection (a) of Section 1 of Article VII of the Constitution to read as follows:

Regular Members

Sec. 1. (a) Regular members—The initiation fee for regular membership shall be based upon the latest price at which a regular membership shall have been sold and transferred to an applicant for membership, otherwise than for a nominal consideration or through a private sale or pursuant to Article IV, Section 1(a)(4), prior to the date when such initiation fee is due. Such initiation fee shall be $1,000, if such sale price shall have been $5,000 or less, and such fee shall be increased by $500 for each additional $5,000, or fraction thereof, by which such sale price shall have exceeded $5,000; but in no case shall such initiation fee exceed $2,500.

Notwithstanding other provisions of the Constitution, an applicant for regular membership who is an associate member on the effective date of this amendment and continues to be such down to the date of the filing of his application for regular membership, or is a general partner or a director holding voting stock in a firm or corporation which was an associate member firm or corporation on the effective date of this amendment and continues to be an associate member firm or corporation down to the date of the filing by such applicant of his application for regular membership, shall not be required to pay any initiation fee.

Amend the first paragraph of subsection (b) of Section 1 of Article VII of the Constitution to read as follows:

Associate Members

(b) Associate members—The initiation fee for associate membership shall be a sum equal to 5% of the latest price at which a regular membership shall have been sold and transferred to an applicant for regular membership, otherwise than for a nominal consideration or through a private sale or pursuant to Article IV, Section 1(a)(4), prior to the date when such initiation fee is due, but in no case shall such initiation fee for associate membership be less than $1,000; provided, however, that the initiation fee for an associate member who is elected as the nominee of a firm or corporation pursuant to Article IV, Section 1(c) shall be $100. Such initiation fee shall become due and be payable on the date on which the application is considered by the Board, and prior to such consideration.

The foregoing amendments, if approved by the required vote of the Regular Members, shall become effective as of the first business day following the final date of the period prescribed for such vote by Article XIII of the Constitution, except that the foregoing amendment of subsection (b) of Section 2 of Article VI shall become effective on July 26, 1963.

Article XIII of the Constitution provides for affirmative voting and makes it desirable that all Regular Members vote either for or against these amendments.

A Ballot, a Return Letter addressed to the Secretary of the Exchange and two return envelopes are enclosed for your use.

VOTING INSTRUCTIONS

1. Vote by marking an X upon the Ballot in one of the spaces provided.
2. Place only the Ballot in the blue envelope and seal it.
3. Sign only the Return Letter.
4. DO NOT SIGN THE BALLOT.
5. Enclose the signed Return Letter and the blue envelope containing the Ballot in the white envelope addressed to the Secretary.
6. Mail or Deliver the white envelope to the Secretary so that it will be in his hands by 4:00 P. M. on April 15, 1963.

H. VERNON LEE, JR.,
Secretary.

[EXHIBIT E]

AMERICAN STOCK EXCHANGE
86 TRINITY PLACE
NEW YORK 6, N. Y.

LISTING STANDARDS, POLICIES AND REQUIREMENTS

Adopted by the Board of Governors on April 5, 1962

The following is the text of the modified listing standards, policies and requirements which the Board of Governors of the American Stock Exchange adopted on April 5, 1962 in line with the recommendations of the Special Committee for Study of the American Stock Exchange.

ORIGINAL LISTING STANDARDS

The American Stock Exchange has adopted the following minimum standards for the determination of whether an Applicant will qualify for listing:

Size (Net Worth):

The Applicant must have net tangible assets of at least $1,000,000.

Earnings:

The Applicant must have net earnings of at least $150,000 after all charges, including Federal income taxes, in the fiscal year immediately preceding the filing of the listing application, and net earnings averaging at least $100,000 for the past three fiscal years.

In special situations the Exchange may consider applications of companies which do not meet the above net earnings standards but which have *substantially larger net worth than the minimum of $1,000,000* specified above. These special situations will be considered on their merits, and will include companies such as the following:

(a) Companies licensed under the Small Business Investment Act of 1958 or qualified as real estate investment trusts under the so-called "Real Estate Investment Act of 1960", provided that the companies have been in operation for at least one year.

(b) Real estate companies operating under the "cash flow" concept, provided that the companies have a "cash flow" income substantially greater than the minimum net after tax earnings specified above for other types of companies.

(c) Companies not yet on a sustained producing and earnings basis which are engaged in the development and/or construction of plants or other facilities and are *fully financed* to complete such program, provided that such companies submit satisfactory evidence of their ability to exceed the above minimum net earnings standard within a reasonable period of time after completion of such fully financed program.

Distribution of Common Stock Issues:

In the case of common stock issues the Exchange requires a minimum public distribution of 200,000 shares (exclusive of the holdings of officers and directors and other concentrated or family holdings) among not less than 750 holders, of whom not less than 500 must be holders of lots of 100 shares or more.

The total number of outstanding shares of common stock must have a minimum aggregate market value of $2,000,000, and the publicly distributed shares a minimum aggregate market value of $1,000,000.

LISTING FEES

Original Listing Applications:

Stock Issues—The original listing fees for stock issues (or long-term warrant issues, based upon the aggregate number of shares the warrants evidence the right to purchase) are as follows:

1¢ per share for first 250,000 shares, and

¼¢ per share for the balance of the shares included in the original listing application (either issued shares or unissued shares to be added to the list on notice of issuance) to a maximum of $5,000 on each original listing application. (If the number of shares applied for in the original listing application exceeds 1,250,000 shares, the maximum fee is applicable.)

Bond Issues—The original listing fees for bond issues are as follows:

$100 per million dollars ($1,000,000) face value, or fraction thereof. Maximum fee on each application $2,500, regardless of the number of bond issues (or the principal amount thereof) applied for in one original listing application. Minimum $500.

Continuing Annual Fee:

$250 per company, payable on September 1 of each year commencing September 1, 1962. The continuing annual fee shall only be charged to companies with listed stock or warrant issues. (No annual fee for companies with only bonds or similar issues listed.)

Supplemental Listing Applications (for listing of additional shares subsequent to original listing):

1¢ per share to a maximum of $2,500 for each application. (If amount applied for in any one application exceeds 250,000 shares, the maximum of $2,500 is applicable.)

Minimum fee on each application $100. (If amount applied for is less than 10,000 shares, the fee is $100.)

The following are included in the pamphlet "Requirements for Original Listing Applications":

VOTING RIGHTS

The American Stock Exchange will not view favorably applications for the listing of (a) Common Stocks which are non-voting or which have unduly restricted voting rights, and (b) non-voting Preferred Stocks which do not acquire voting rights upon specified defaults (maximum two years) in the payment of fixed dividend requirements. However, in applying the above policy the Exchange will consider each case individually and on its own merits, and may make certain exceptions thereto depending upon the c. umstances in each case.

A statement of the Exchange's policy (and possible exceptions thereto) will be furnished upon request. The staff of the Division of Securities will discuss this policy and furnish an opinion in any particular case.

PRINTING AND ENGRAVING REQUIREMENTS

The Exchange requires that listed securities (stocks and bonds) be prepared with steel engraved borders in a form prescribed by the Exchange, and prepared by recognized Bank Note Companies. The Division of Securities will discuss this requirement with representatives of prospective applicants for listing, and examine proofs or specimens of their securities.

LISTING AGREEMENTS

The listing agreements of the American Stock Exchange are amended and amplified to include the following:

Agreement re proxy solicitation for all stockholders' meetings:

"The Corporation will solicit proxies (pursuant to proxy statements conforming to the proxy rules of the Securities and Exchange Commission) for all meetings of stockholders at which holders of voting stocks listed on the Exchange have the right to vote."

(See policies of the Exchange requiring a vote of stockholders in connection with (a) options to officers, directors and key employees, as set forth below and (b) certain acquisitions, as set forth on page 4 hereof.)

Agreement re quarterly reports of earnings:

"The Corporation will publish quarterly statements of earnings on the basis of the same degree of consolidation as in the annual report. Such statements will disclose any substantial items of unusual or non-recurrent nature and will show either net income before and after federal income taxes or net income and the amount of federal income taxes."

Note: The statements (unaudited) need not be detailed income accounts, but merely summary statements of sales and net income, and may cover each quarter individually or the elapsed quarters of the current fiscal year on a cumulative basis. No statement is required for the fourth quarter since that period is covered by the annual report. It is recommended that each interim statement show comparative figures for the same period of the previous year. These statements should be published within five weeks after the end of each fiscal quarter.

The above agreement does not require that the interim statements (unaudited) be sent to stockholders (unless the Corporation so desires) but they should be distributed in the form of a press release to one or more newspapers of general circulation in New York regularly publishing financial news, or to one or more of the national news-wire services, and to the news-ticker service operated by Dow Jones & Co. Inc. at 44 Broad Street, New York 4, N. Y. *Copies should also be sent to the American Stock Exchange.*

Exceptions may be made to this requirement only in cases where conditions peculiar to the type of company, or to the particular company itself, would make quarterly statements impracticable or misleading, as in the case of companies dependent upon long-term contracts, or companies dependent upon the growth and sale of a crop in an annual cycle, or companies (such as race-track companies) operating under conditions which make publication of quarterly statements virtually impossible or misleading.

In a case where the Exchange is convinced that quarterly statements are impracticable, or misleading, it may require an agreement to publish semi-annual statements of earnings, or interim statements reporting certain operating statistics which will serve to indicate the trend of the company's business during the period between annual reports. Only when the Exchange is convinced that any type of interim statement is either impracticable, or misleading, will an agreement calling merely for publication of annual statements be accepted.

NOTE: After adoption of the above listing agreements regarding solicitation of proxies and quarterly earnings reports (a) all applicants for original listing and (b) all presently listed companies which file supplemental listing applications will be required to sign the usual form of listing agreement which will include the above additions, and the agreements will be in effect from the date of such signing.

POLICIES RELATING TO APPLICATIONS SUBSEQUENT TO ORIGINAL LISTING

In connection with the following policies pursuant to which stockholders' approval is required as a prerequisite to the listing of new or additional securities of a listed company, the minimum vote which will constitute stockholder approval for listing purposes is defined as "approval by a majority of votes cast on a proposal in a proxy bearing on the particular matter, provided that the total vote cast on the proposal represents over 50% in interest of all securities entitled to vote on the proposal."

Options to Officers, Directors or Key Employees:

The Exchange has revised and clarified the policy adopted in June 1961 to read as follows:

"Approval of stockholders will be required as a prerequisite to approval of applications to list additional shares reserved for options granted or to be granted to officers, directors or key employees, regardless of whether or not such authorization is required by law or by the Corporation's charter. The Exchange requires that such stockholders' approval will be solicited pursuant to a proxy statement conforming to the proxy rules of the Securities and Exchange Commission which will disclose all of the essential details of the options or of the plan pursuant to which the options will be granted. This policy does not preclude the adoption of a stock option plan, or the granting of options, subject to ratification by stockholders prior to the filing of an application for the listing of the shares reserved for such purpose. The Exchange may not require stockholders' authorization of options in cases (a) where options are issued to an individual, not previously employed by the Corporation, as an inducement essential to his entering into a contract of employment with the Corporation, and (b) where options are issued under a plan in which all, or substantially all, of the Corporation's employees participate, depending upon the maximum amount issuable to any one individual under the plan and the proportionate distribution contemplated by the plan."

Stockholders' Approval of Acquisitions in certain circumstances:

The Exchange has revised and clarified the policy adopted in July 1961 to read as follows:

Approval of stockholders will be required (pursuant to a proxy solicitation conforming to the proxy rules of the Securities and Exchange Commission) as a prerequisite to approval of applications to list additional shares to be issued as sole or partial consideration for an acquisition of the stock or assets of another company in the following circumstances:

(a) If any director, officer or substantial stockholder of the listed company has an interest, directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction.

(b) If the acquisition will result directly or indirectly in an increase of 20% or more in the number of outstanding shares of the listed class of stock (including for the purpose of this calculation any shares issuable in conversion of convertible securities issued in the transactions).

(c) If the market value of the additional shares to be issued plus the fair value of any other consideration to be paid in the transaction equals 20% or more of the aggregate market value of the outstanding shares of the listed class of stock.

Acquisition of a Listed Company by an Unlisted* Company:

The Exchange will not approve an application to list additional shares of a listed company (or shares of a different surviving company) in any combination of a listed company with an unlisted company which, in the opinion of the Exchange, would result in the acquisition of the listed company by the unlisted company, *unless the company resulting from the combination meets the original listing standards of the Exchange.* The type of combination to which this policy relates is a so-called "back-door" listing generally resulting from a plan of acquisition, merger or consolidation the net effect of which is that a listed company is acquired by an

* The above reference to "unlisted companies" refers primarily to companies with no stock issues dealt in on the Exchange, but also includes companies with stock issues admitted to unlisted trading privileges on the Exchange.

unlisted company, regardless of which company is the survivor in the combination. In applying this policy consideration will be given to all relevant factors, including the proportionate amount of the securities of the resulting company to be issued to each of the combining companies, changes in ownership or management of the listed Company, whether the unlisted company is larger than the listed company, the nature of the businesses being combined, etc.

The Exchange recommends that any proposed plan of the above nature, including particularly any plan under which stockholders of the listed company would own less than 50% of the shares or voting power of the resulting company, be submitted for an informal opinion before its promulgation.

Split-ups or Stock Dividends on Lower Priced Issues:

The Exchange does not view favorably a split-up of a stock selling in a low price range or a split-up or substantial stock dividend which may result in an abnormally low price range for the shares after the split or stock dividend. Any company considering a split-up *(or a stock dividend of more than 5%)* which would result in an adjusted price of less than $7.50 per share for its stock should consult with the Division of Securities of the Exchange in advance of taking formal action.

NOTE: The above is in addition to the policy which the Exchange has invoked for some years which provides that

> "* * * The American Stock Exchange expects that the transactions will be accounted for in accordance with Accounting Research Bulletins of the American Institute of Accountants, *i. e.* if the distribution is less than 25%, the Corporation should account for the transaction by transferring from Earned Surplus an amount equal to the fair value of each of the additional shares to be issued, with Capital Stock Account increased by the par value of the shares, and Capital Surplus Account increased by the amount by which the fair value of the shares issued exceeds the par value. * * *"

DELISTING POLICIES

The Constitution of the American Stock Exchange provides that the Board of Governors may in its discretion at any time, and without notice, suspend dealings in or may remove any security from listing or from unlisted trading.

The American Stock Exchange does not rate or evaluate any security dealt in on the Exchange, but as a matter of policy the Exchange will consider the suspension of trading in, or removal from listing or unlisted trading of, any security when

(a) the financial condition and/or operating results of the issues are such as, in the opinion of the Exchange, do not warrant continuation of the security on the list, or

(b) when it appears that the extent of public distribution of the security has become so reduced as to make inadvisable further dealings therein upon the Exchange.

In furtherance of these policies, the American Stock Exchange has adopted certain criteria under which it will give consideration to suspending dealings in, or removing a security from listing or unlisted trading, as follows:

1. **Lack of Earnings:**

   If the Company has not operated at a net profit in at least one of the last three fiscal years. This policy will be applied with due consideration of the nature of the company's business. Companies operating under the "cash flow" concept or other special types of situations which are not showing earnings because of the nature of their set-up (such as holding companies not deriving dividend income from unconsolidated subsidiaries which are operating profitably, etc.) would not, under ordinary circumstances, be considered as candidates for delisting.

2. Limited Distribution of Securities:

Common Stock:

If (a) shares publicly held, exclusive of management or other concentrated holdings, decline to 70,000 shares or less, or

(b) stockholders of record are less than 250 or if there are less than 150 holders of lots of 100 shares or more, or

(c) the aggregate market value of all outstanding shares of common stock is less than $1,000,000, or the aggregate market value of shares publicly held (exclusive of management or other concentrated holdings) is less than $500,000.

Preferred Stock and Similar Issues:

If (a) market value, exclusive of concentrated holdings, is $400,000 or less, or

(b) amount outstanding, exclusive of concentrated holdings, is 10,000 shares or less.

Bonds:

If market value or principal amount outstanding, exclusive of concentrated holdings, is $200,000 or less.

3. Disposal of Principal Operating Assets:

The Exchange will consider the suspension or removal of an issue (listed or admitted to unlisted trading) if the company has sold or otherwise disposed of its principal operating assets, or has ceased to be an operating company. If the issuer is in process of liquidation, trading in the issue may be continued until the initial liquidating distribution is made.

CONFIDENTIAL

[EXHIBIT F]

AMERICAN STOCK EXCHANGE

Securities Division

November 1, 1963

TO: Board of Governors

FROM: Committee re Possible Delistings

SUBJECT: Final Report on the Committee's Activities.

The Committee re Possible Delistings was appointed by the President on September 6, 1962, with the approval of the Board of Governors, to make a case-by-case study of issues traded on the Exchange in light of the delisting policies adopted by the Board of Governors on April 5, 1962.

In the interval between April 5, 1962 and September 6, 1962 the Securities Division had prepared worksheets covering all of the stock issues then listed or admitted to unlisted trading privileges on the Exchange, and had initiated correspondence with a large number of companies which, according to the Exchange's criteria, were scheduled for consideration for delisting.

The original list of such issues totalled 110, but 13 issues had been delisted during the Summer of 1962 on recommendation of the former Committee on Securities. This reduced the list to 97. In the intervening months, as new data became available, 34 issues were added bringing the total to 144. The following tabulation shows the disposition of these 144 issues:

Removed or Suspended	-	63 Issues (including 4 still suspended - not yet delisted)
Extensions Granted	-	75
Action Pending	-	6

Sixteen of the issues for which extensions were granted are no longer being considered for delisting, for the following reasons:

Ten reported net profits in their latest fiscal year.

Two have been merged with other corporations showing profits.

Two effected split-ups to improve share distribution above the Exchange's minimum requirements.

Two were not delisted for other reasons - one because its distribution increased and one Preferred stock issue because the Company has other issues listed. (See pages 1 and 2 of Exhibit B.)

(*** Three lists covering issues removed or under consideration for removal not included).

The Committee feels that its work is substantially completed and that cases which are still pending, or which may develop, should now be handled by the Securities Division with recommendations channeled through the Advisory Committee to the Board of Governors. Several recent delisting matters have, in fact, been handled in this manner.

In its consideration of various listing and delisting problems the Committee and staff have explored a number of policies which may require some revision to make them more responsive to the needs of the Exchange and listed companies. These will be the subject of special memoranda and recommendations to the Board of Governors in the near future.

The Committee would like to commend the staff of the Securities Division for the excellent manner in which material was researched and prepared, conferences with companies were conducted, and appropriate reports were drafted.

Solomon Litt, Chairman
James E. Thomson, Vice Chairman
Emil J. Hausmann
Edward W. Kraebel
Norman M. Leff
W. Allen Taylor
William C. Willis, Jr.

[EXHIBIT G]

86 TRINITY PLACE
New York 6, N. Y.
Telephone REctor 2-0600

AMERICAN STOCK EXCHANGE

DIVISION OF SECURITIES

REQUIREMENTS FOR ORIGINAL LISTING APPLICATIONS STOCKS—LONG TERM WARRANTS—BONDS

Amended to May 16, 1963

This pamphlet contains instructions applicable to applications for original listing of stocks, long-term warrant issues and bonds.

A separate supplementary pamphlet will be supplied upon request containing additional information and papers required in connection with applications for special types of issuers or securities as follows: Investment Corporations, Corporations in process of reorganization or recently reorganized, Foreign Corporations—Voting Trust or Stock Trust Certificates, Deposit Receipts, Certificates of Deposit, etc.

ORIGINAL LISTING STANDARDS

The American Stock Exchange has adopted the following minimum standards for the determination of whether an applicant will qualify for listing:

Size (Net Worth):

The applicant must have net tangible assets of at least $1,000,000.

Earnings:

The applicant must have net earnings of at least $150,000 after all charges, including Federal income taxes, in the fiscal year immediately preceding the filing of the listing application, and net earnings averaging at least $100,000 for the past three fiscal years.

In special situations the Exchange may consider applications of companies which do not meet the above net earnings standards but which have substantially larger net worth than the minimum of $1,000,000 specified above. These special situations will be considered on their merits, and will include companies such as the following:

(a) Companies licensed under the Small Business Investment Act of 1958 or qualified as real estate investment trusts under the so-called "Real Estate Investment Act of 1960", provided that the companies have been in operation for at least one year.

(b) Real estate companies operating under the "cash flow" concept, provided that the companies have a "cash flow" income substantially greater than the minimum net after tax earnings specified above for other types of companies.

(c) Companies not yet on a sustained producing and earnings basis which are engaged in the development and/or construction of plants or other facilities and are fully financed to complete such program, provided that such companies submit satisfactory evidence of their ability to exceed the above minimum net earnings standard within a reasonable period of time after completion of such fully financed program.

Distribution of Common Stock Issues:

In the case of common stock issues the Exchange requires a minimum public distribution of 200,000 shares (exclusive of the holdings of officers and directors and other concentrated or family holdings) among not less than 750 holders, of whom not less than 500 must be holders of lots of 100 shares or more.

The total number of outstanding shares of common stock must have a minimum aggregate market value of $2,000,000, and the publicly distributed shares a minimum aggregate market value of $1,000,000.

Preliminary Opinion Prior to Preparation of Complete Listing Application

An informal and confidential opinion as to the eligibility of a particular issue for listing may be obtained in advance of the preparation and filing of a complete listing application, by sending to

the Division of Securities of the Exchange (a) copy of the latest prospectus of the company (if comparatively recent), (b) copies of printed annual reports distributed to stockholders for the past three years (if available) or financial statements for such periods, and (c) a certificate showing a breakdown of the extent of the public distribution of the stock, the latter on a printed form (Listing Form K) which will be supplied by the Exchange upon request.

VOTING RIGHTS

The American Stock Exchange will not view favorably applications for the listing of (a) Common Stocks which are non-voting or which have unduly restricted voting rights, and (b) non-voting Preferred Stocks which do not acquire voting rights upon specified defaults (maximum two years) in the payment of fixed dividend requirements. However, in applying the above policy the Exchange will consider each case individually and on its own merits, and may make certain exceptions thereto depending upon the circumstances in each case. A statement of the Exchange's policy (and possible exceptions thereto) will be furnished upon request. The staff of the Division of Securities will discuss this policy and furnish an opinion in any particular case.

PROCEDURE FOR COMPLETE LISTING APPLICATION

Each complete application for listing consists of the following:

(a) The application, signed by an executive officer of the applicant corporation, and prepared in the form outlined in the applicable portion of this pamphlet.

(b) The separate supporting papers specified in the applicable portion of this pamphlet.

In addition, each applicant for listing is required to file with the Exchange an executed copy (complete with all exhibits) of its application for registration under the Securities Exchange Act of 1934, as referred to below under the caption "Registration under the Securities Exchange Act of 1934".

No prepared or blank forms are available for the listing application itself. The applicant prepares its own application, in typewritten narrative form, following the instructions as to the form and content thereof as outlined in the appropriate portion of this pamphlet. Applicants will find reference to a recently approved listing application of a type similar to their own of assistance in the preparation of their application, and the Division of Securities of the Exchange will furnish such specimen applications upon request. The employees of said division will also advise and assist in the preparation of applications to list whenever so requested.

Three preliminary typewritten drafts of the listing application (each copy signed by an executive officer of the applicant corporation) accompanied by financial statements in duplicate and one copy of each of the required supporting papers and documents, should be initially filed with the Division of Securities for examination. If, as the result of such examination, any deficiencies are noted, or any changes are considered necessary in the form or contents of the application and supporting papers, a list thereof will be furnished the representative of the applicant. After the corrected and additional data have been filed, the listing application proper is set up in the form of a printer's proof and is then ready for presentation to the Board of Governors.

After securities have been approved for listing by the Exchange, and before such securities may be admitted to trading on the exchange, they must be registered under the Securities Exchange Act of 1934, as referred to below. In the interval between the approval of the listing application by the Exchange and the effective date of registration under the Securities Exchange Act, the final draft of the listing application, in the form as signed and filed by the applicant (including therein the financial statements submitted by the applicant), will be printed for distribution to members of the American Stock Exchange and others. Applicant corporations are required to pay the cost of printing the 600 copies required for this purpose, being billed directly by the printer.

SHORT-FORM LISTING APPLICATION INCORPORATING PROSPECTUS OR PROXY STATEMENT BY REFERENCE

A simplified procedure is permitted in respect of listing applications if a prospectus relating to the securities applied for is in process of issuance or has been issued in accordance with the requirements of the Securities Act of 1933 within a reasonably short period prior to the date on which the listing application is filed. In such cases, at the option of the applicant, any of the data required in the listing application may be incorporated by reference to the prospectus. Where this is done, the prospectus shall be attached to and made part of the listing application. The listing application itself shall contain all required data not included in the prospectus. In ordinary cases, such short-form listing applications are limited to a few of the items required in long-form applications as outlined on page 3, and an additional

item titled "Prospectus" is inserted, referring to and incorporating the prospectus by reference, and indexing the information contained therein.

The above procedure is also permitted in cases where a proxy statement, prepared in accordance with the proxy rules (Regulation X-14) of the S. E. C., is available, describing the transaction pursuant to which the securities applied for are to be issued, provided that the proxy statement includes sufficient information with respect to the history, business and properties of the applicant.

Applicants which follow this procedure should reserve 700 copies of the prospectus (or proxy statement) for delivery to the printer for attachment to the final printed copy of the short-form listing application, for distribution to the mailing list of the Exchange. Applicants which use the short-form application should also submit all of the supporting papers and exhibits specified on pages 7, 8 and 9 below.

REGISTRATION UNDER THE SECURITIES EXCHANGE ACT OF 1934

Securities which have been approved for listing by the Exchange must be concurrently registered under the Securities Exchange Act of 1934 before they may be admitted to trading on the Exchange. Such registration is required regardless of the fact that the applicant may have previously registered all or part of its securities under the Securities Act of 1933 in connection with a prior public offering.

Registration under the Securities Exchange Act of 1934 cannot become effective until after the issue has been approved for listing by the Exchange. Upon such approval, the Exchange is required to certify to the Securities and Exchange Commission that it has received its copy of the registration application and has approved the particular securities for listing and registration. Ordinarily registration becomes effective automatically thirty days after receipt by the Commission of the Exchange's certification, but may become effective within a shorter period, by order of the Commission, upon request for acceleration of the effective date made by the Company to the Commission.

The registration forms under the Securities Exchange Act of 1934 vary in respect of different types of issuers or securities, although Form 10 is applicable in the great majority of cases. The Division of Securities will supply applicants for listing with copies of the proper registration forms to be used by them and the instruction book of the Securities and Exchange Commission applicable thereto. In many respects these registration forms call for information substantially similar to that contained in listing applications, and most applicants find it preferable to prepare their listing and registration applications coincidentally, and to file the Exchange's copy of the registration application with the Exchange at the same time as the listing application and supporting papers. In any event it is advisable to file the registration application not later than the date upon which the listing application is to be acted upon by the Board of Governors, for if a copy thereof has not been filed by that date the Exchange must, notwithstanding its approval of the listing application, defer certification to the Securities and Exchange Commission until the copy of the registration statement has been received, thus delaying the effective date of registration, and the date as of which the security may be admitted to trading on the Exchange.

Under the rules of the Securities and Exchange Commission, three complete copies of the 1934 Act registration application including exhibits and all other papers and documents filed as a part thereof shall be filed with the Commission. One copy of such application, complete with all exhibits, shall be filed with the American Stock Exchange. If the application is typewritten, one of the copies filed with the Commission shall be a "ribbon" copy. At least one copy of the application filed with the Commission and the copy thereof filed with the Exchange shall be manually signed in the manner prescribed by the appropriate form. If the application is typewritten, the ribbon copy shall be signed. Unsigned copies shall be conformed.

ORIGINAL LISTING OF STOCK

Form and Content of Application (when short-form is used).

When the short-form listing application is used, incorporating the prospectus (or proxy statement) by reference, the listing application will, in ordinary cases, be limited to Items 1, 2 (a) to (d) inclusive, 3, 8, 9, 13 (where applicable), 17, 19 and 20 of the information required in long-form listing applications, as outlined below, and an additional item titled "Prospectus" (or "Proxy Statement") will be inserted, referring to and incorporating such document by reference, and indexing the information contained therein.

Applicants which follow the short-form procedure should reserve 600 copies of the prospectus (or proxy statement) for delivery to the printer for attachment to the final printed copy of the short-form listing application for distribution to the mailing list of the Exchange. Applicants which use the short-form listing application should also submit all of the supporting papers and exhibits specified or pages 7, 8 and 9 hereof.

Form and Content of Application (when long-form is used).

An application for original listing of stock shall recite, in substantially the order given below, the following:

1. The title page, showing
   - A. The name of the applicant, and when and where incorporated.
   - B. Class of stock applied for and the par value thereof.

C. Date of application, and formal request for listing, specifying the amount, class and par value of the security applied for, whether fully paid, non-assessable, and whether personal liability attaches to ownership.

Application shall be made to list only that part of an issue which is actually issued and outstanding. If an additional unissued amount is reserved for issuance for a specific purpose, application may also be made for authority to add that amount to the list "upon official notice of issuance" in future for that specific purpose. An additional listing fee is payable in connection with the listing of such additional amount, as outlined on page 15. The request for authority to list such additional amount should state briefly, but specifically, the purpose for which it is reserved for issuance, and the authorization for listing such shares is effective only if the securities are issued for that purpose. No additional unissued amount may be applied for which is not reserved for issuance for any specific purpose.

2(a). CAPITALIZATION. In tabulated form, the following: (1) designation or title of each class of stock, (2) par value, (3) number of shares, (a) authorized by charter, (b) authorized for issuance (including unissued reserved shares), (c) outstanding, and (d) applied for.

2(b). As a footnote to "Capitalization", insert tabulation showing number of unissued shares of each class of stock reserved for issuance for any purpose, and purpose for which reserved. If no unissued stock reserved for issuance for any purpose, so state.

2(c). If information re. Control, as called for by item 2(c) on page 6 hereof is applicable, it should be inserted at this point in application.

2(d). State number of stockholders of record (of the class applied for) as of a specified recent date.

3. LONG TERM OR FUNDED DEBT. In tabulated form, show, for each issue or series of long term or funded debt of the applicant and subsidiary or controlled companies, the following: (1) full title (including interest rate and maturity date), (2) amount authorized by indenture, (3) amount issued to date, (4) amount redeemed, and (5) amount outstanding.

Note: In the case of an applicant which files a "long" Form 10 Securities Exchange Act of 1934 registration application (not incorporating by reference a previously effective registration under the Securities Act of 1933), the text of the following "History and Business" and "Properties" items in the listing applications should conform to the text of the equivalent items (3) and (4) of the Form 10 registration application.

4. HISTORY AND BUSINESS. Brief history of the business or enterprise from inception to the date of the application. If organized as the result of merger, consolidation or reorganization, trace similarly the history of the predecessor companies. If organized through reorganization, describe briefly the circumstances leading to, and the effect of, the reorganization. Description of the nature of the business now conducted by the Company and its subsidiary or controlled companies, including principal products manufactured or services performed, principal markets for products and raw materials, method of marketing and distributing products, annual output for preceding five fiscal years and for the current fiscal year to latest date available (in terms of physical units if practicable; otherwise in terms of dollar volume), backlog of unfilled orders on hand as of specified recent date, if applicable to type of business, giving percentage of such backlog represented by defense production items and commercial items, and whether such orders are firm.

Indicate briefly, to the extent material, the general competitive conditions in the industry in which the applicant and its subsidiaries are engaged or intend to engage, and the position of the enterprise in the industry. If several products or services are involved, separate consideration should be given to the principal products or services or classes of products or services.

If information re Patents, etc., and called for by item 4(a) on page 6 hereof is applicable, it should be inserted at this point in application.

Note: Oil, Mining and Public Utility companies are referred to pages 9 to 11 of this pamphlet which specify alternative information to be included under "History and Business" and "Properties".

5. PROPERTIES. Describe briefly (either by groups of plants or other units) the general character of the principal plants and other important units or properties of the applicant and its subsidiaries, including (1) location, (2) land area, (3) number of buildings and type of construction, (4) aggregate floor area of buildings, (5) condition of equipment, transportation facilities and (6) productive capacity (in terms of units of production, if possible). State whether properties are owned or leased, and if leased state total rentals paid during last fiscal year and average term of leases.

(Note: The statement required by this item should include the plants and units of subsidiaries of the applicant only insofar as they constitute principal plants or other important units of the total enterprise represented by the applicant and its subsidiaries. The statement and any description under this item are to be only in general terms. The particularity of the statement or description as to any plant or unit must be governed by its importance with relation to the total business of the applicant, and its subsidiaries. In any case, a legal description by metes and bounds shall not be given.)

6. EMPLOYEES—LABOR RELATIONS. State total number of regularly employed and, if subject to seasonal fluctuations, the maximum and minimum numbers employed during the preceding twelve months.

State dates and duration of material work stoppages due to labor disagreements during the past three years and the general terms of settlement of such disagreements.

7. STOCK PROVISIONS. If application is being made to list stock, give a summarized statement of the rights, preferences, privileges and priorities of the class of stock applied for and of each class on a parity therewith or senior thereto. Describe fully any provisions of indentures or other agreements restricting payment of dividends or affecting voting rights of the class of stock applied for. State whether or not stockholders of any class have pre-emptive rights to subscribe to additional issues, whether by charter provision or statute.

8. REGISTRATION WITH SECURITIES AND EXCHANGE COMMISSION. State whether securities applied for (or any portion thereof) have been registered under Securities Act of 1933. If securities (or any portion) have not been so registered, a statement must be made that legal opinion has been received that registration has not been and is not now required, the section of said Act or the rule of the Commission under which exemption from registration was claimed, and the basis of such claim for exemption.

State that application is being filed concurrently with the Securities and Exchange Commission for the registration on the American Stock Exchange of the securities applied for under the provisions of the Securities Exchange Act of 1934.

9. OPINION OF COUNSEL. Specify the name and address of counsel rendering the opinion filed in support of the listing application as to (1) validity of authorization of securities and (2) the exemption from registration under the Securities Act of 1933 of any securities (or any portion) applied for if such exemption is claimed. If such counsel, or any partner of such counsel (or, if a firm, any member thereof) is an officer, director or stockholder of the applicant, this fact must be stated.

10. SUBSIDIARY AND AFFILIATED COMPANIES. A tabulated list of all subsidiary or controlled companies, including all companies in which the applicant owns or controls, directly or indirectly, 50% or more of the voting power, showing as to each such company (a) name of company, (b) brief statement of nature of business and relationship to operations of entire enterprise, and (c) capital stock issues by classes, showing par value, amount authorized, amount outstanding, amount owned by parent corporation. If the applicant has a substantial interest (but less than control) in any company or organization, such interest should be described.

11. RECENT SALES OF SECURITIES. For all securities of the applicant sold or issued within three years furnish, in tabulated form, (a) title of issue, (b) amount sold, (c) date of sale, (d) net cash proceeds, or the nature and amount of any consideration other than cash, and (e) the purpose(s) to which such proceeds were applied, showing the approximate amount devoted to each purpose.

12. OPTIONS. Recite a summary of the essential provisions of any options, purchase warrants, or similar contracts or agreements in effect, stating briefly amounts, prices, expiration dates, and other material conditions, and name(s) of optionee(s).

13. DIVIDEND RECORD. State the number of consecutive years in which dividends have been paid. State the amount of dividends (per share and in the aggregate) paid by the applicant (or its predecessors) each year for the five preceding years. Indicate whether dividends have been paid on a quarterly, semi-annual or annual basis. State the record date, payment date and date of declaration, with respect to each dividend paid during the past two years. Show stock dividends separately, indicating, in respect of each such dividend, the percentage amount thereof, the number of shares issued in payment, the amount per dividend share and in the aggregate charged against earnings or earned surplus, and the basis for determination of the amount so charged. State the aggregate and per share amount of any dividend arrearages.

14. BONUS, PROFIT-PARTICIPATION, PENSION, AND RETIREMENT PLANS.

(a) Describe briefly every material bonus or profit-participation plan provided by the applicant or its subsidiaries in which directors or officers of the applicant are eligible to participate, and state the basis of their participation therein. State for the last fiscal year the total amount paid or set aside by the applicant and its subsidiaries pursuant to each such plan.

(b) Briefly describe every material pension, retirement, savings or similar plan wholly or partly for the benefit of directors or officers of the applicant to which the applicant or its subsidiaries contribute. State for the last fiscal year the annual payments made by the applicant and its subsidiaries pursuant to each such plan with respect to (1) past services and (2) future services.

15. LITIGATION. Describe all pending litigation of a material nature in which the company, or any of its subsidiary or controlled companies, may be involved which may affect its income from, title to, or possession of, any of its properties.

16. MANAGEMENT. Names, titles and addresses of all directors and officers.

17. GENERAL INFORMATION. Under this caption state:

Address of principal executive offices.

State or other sovereign power under which incorporated, date of incorporation, and date of termination of charter.

Date on which fiscal year ends.

Date and place of annual stockholders' meeting; percentage of voting stock constituting a quorum for meeting of stockholders.

Name(s) of transfer agent(s) with address(es) of each.

Name(s) of registrar(s) with address(es) of each.

18. BUSINESS, FINANCIAL AND ACCOUNTING POLICIES.

Consolidation: Indicate the principle followed with respect to consolidation, in inclusion or exclusion of companies. Indicate whether all companies included in the consolidation employ the same principles of accounting. If not, indicate the nature of any substantial divergence.

Depreciation: Describe in reasonable detail the policy as to depreciation. Such description should state the method of depreciation followed; i.e., "straight line," etc., and the theory underlying that method. Rates employed as to major classes of property should be stated in tabulated form.

Depletion: If assets subject to depletion are material, describe policy as to depletion. Show basis on which depletion is charged and the theory underlying such basis.

Amortization (other than depreciation): State the policy followed with respect to patents or other items which in ordinary practice are capitalized and amortized.

In cases where, because of the nature of the industry or circumstances peculiar to the applicant, business, financial or accounting policies other than those outlined above are considered material in determining the applicant's income or financial position, or in interpretation of its financial statements, describe such other policies.

19. FINANCIAL STATEMENTS. Specify what financial statements are being submitted (separately) as an essential part of the listing application (See Paper A, page 7) and request the inclusion thereof in the application when printed.

20. CERTIFICATE. Certificate and signature of duly authorized officer of the applicant corporation.

The following additional information should be included in the appropriate part of application, if applicable:

2(c). CONTROL. If, in any registration statement filed under the Securities Act of 1933 or the Securities Exchange Act of 1934, the applicant has stated that any corporation, individual, or other entity possesses, directly or indirectly, the power to direct or cause the direction of the management and policies of the applicant, whether through the ownership of voting securities, by contract, or otherwise, similar information should be included in the listing application, i.e., state the name of the holder of such control and indicate, to the extent the information is available to the applicant, the extent of such ownership or control.

4(a). PATENTS AND LICENSE AGREEMENTS, ETC. If a material part of the business is dependent upon patents, patent rights, licenses, processes, or similar intangible assets owned, controlled or operated under by either the applicant or any of its subsidiaries, furnish a list of same showing (1) serial number and brief description (subject matter) of each, (2) date of expiration, (3) whether (a) in development, (b) in active use, or (c) dormant, and (4) state whether any suits are pending regarding same, and if so, describe.

If the applicant or subsidiaries pay or receive any substantial royalties (or similar payments) in connection with any of the above, furnish details of the agreements, including (1) amount of royalty or income paid or received (or payable or collectible), and (2) provisions for cancellation of agreement in event of non-performance by parties thereto.

NOTE: A LIST OF THE PAPERS AND EXHIBITS REQUIRED TO BE FILED IN SUPPORT OF APPLICATIONS FOR ORIGINAL LISTING OF STOCK APPEARS ON PAGES 7, 8 AND 9 OF THIS PAMPHLET.

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PAPERS TO BE FILED WITH APPLICATIONS FOR ORIGINAL LISTING OF STOCK

In addition to submitting the application for the original listing of stock (as described on pages 3, 4, 5 and 6) the following papers must be filed in support of such an application:

If any of the following papers are not filed because they are not applicable in any case, submit a separate exhibit, signed by an executive officer of the applicant corporation, in which a statement is made as to why such papers are not applicable.

A. FINANCIAL STATEMENTS. Applicants which use the short-form of listing application incorporating the prospectus or proxy statement by reference should submit (separately) two copies of the prospectus or proxy statement in which the accountants have manually signed their certificate relating to the financial statements contained therein. If the statements contained therein have been prepared as of and to a date more than ninety days prior to the date of the listing application, the "Supplementary Financial Statements" referred to below should also be submitted separately in duplicate. These supplementary financial statements will be printed at the end of the short-form listing application.

If the applicant does not use the short-form listing application, the following financial statements must be submitted in duplicate. Such statements will be included as part of the listing application when the same is printed for distribution.

Independently Certified Financial Statements:

(1) Balance Sheet, in reasonable detail, as of the close of the latest fiscal year ended prior to the date of the listing application.

(2) Comparative Statements of Income and Profit and Loss, in reasonable detail, for each of the three fiscal years preceding the date of the listing application (i. e., to the date of the above Balance Sheet), if the applicant has been in existence that long, or for such lesser period as the applicant has been in business. In the case of applicant companies which are developing and have not yet reached production, a Statement of Cash Receipts and Disbursements from inception should be submitted.

(3) Comparative Analysis of Surplus, in reasonable detail, for the same period covered by the Profit and Loss Statements submitted pursuant to (2) above. Paid-in Surplus, Capital Surplus, Surplus arising from revaluations and other increases must be clearly separated from Earned Surplus.

Note: Where significant, schedules of details of items contained in the foregoing statements may be required.

The above financial statements must be prepared and certified by a properly qualified practicing Public Accountant(s) or Certified Public Accountant(s), who shall, if requested, submit to the American Stock Exchange a statement setting forth his or their qualifications. The accountant's certificate should be manually signed, and should conform to the standard prescribed by the American Institute of Accountants.

Supplementary Financial Statements:

If the independently certified financial statements submitted pursuant to the above requirement have been prepared as of and to a date which is more than ninety days prior to the date of the listing application, such statements shall be supplemented by corresponding statements, similar in form and content, as of and to a date not more than ninety days prior to the date of the listing application, which supplementary financial statements will, in ordinary cases, be accepted either (a) independently certified, or (b) certified by the chief accounting officer of the applicant corporation. Such interim statements should be submitted in duplicate.

The interim statements should carry appropriate footnotes generally equivalent, if applicable, to the footnotes to the independently audited statements as of and to the previous fiscal year end, but revised and amplified to cover any changes therein since the last fiscal year end. If desired, a statement may be made referring to and incorporating by reference the notes to the audited financial statements for the previous fiscal year end, and specifying that such notes are applicable to the interim statements "subject to" (specify any changes or additions therein since the date of the last fiscal year end).

The financial statements should be prepared on a consolidated basis if the applicant has subsidiaries. If there are any subsidiary or controlled companies not included in the consolidated financial statements, the consolidated income account should carry a footnote reflecting the parent company's proportion of the undistributed profit or of the losses of such companies for the period of the report. There should also be a footnote to the consolidated balance sheet showing the amount by which the parent company's equity in the unconsolidated subsidiary or controlled companies has increased or decreased since the date of acquisition as a result of profits, losses and distributions.

The Exchange may require that separate financial statements of any such unconsolidated subsidiary or controlled company be furnished for inclusion in the listing application if the investment in such company represents a substantial part of the assets of the applicant corporation.

All financial statements are submitted to the Consulting Accountants appointed by the American Stock Exchange for approval as to form, content, and agreement with the requirements. Any inquiries as to accounting procedure will be answered by them only through the medium of the Exchange.

B. CHARTER. One copy each of Charter or Articles of Incorporation and all amendments to date, with (manually signed) Certificate(s) of Secretary of State or corresponding authority covering filing of the original Articles and each amendment. In lieu of the foregoing, the applicant may submit a copy of the Charter or Articles of Incorporation as amended to date, with (manually signed) Certificate(s) of Secretary of State or corresponding authority with respect thereto. Photostatic copies acceptable.

C. BY-LAWS. One copy of the By-Laws as amended to date of application, certified by the Secretary or other executive officer of the applicant corporation.

(a) The Exchange requires that at least ten days' written notice be given stockholders in advance of both annual and special stockholders' meetings. If the By-Laws do not provide for such notice, furnish certified copies of amendment to such section of the By-Laws as may be necessary in order to conform with said requirement.

(b) The Exchange requires all applicants to furnish an amendment to the By-Laws or resolution of the Board of Directors to the effect that in the event dividends are declared, stock transfer books will not be closed but that a record date will be set by the company, upon which the transfer agent will take a record of all stockholders entitled to the dividend without actually closing the books for transfers of stock. This eliminates a great deal of confusion, delay and expense.

D. SPECIMEN CERTIFICATES. One specimen copy of each denomination of stock certificate of class of stock to be listed. If Transfer Offices and Registrars are maintained in more than one city, furnish one specimen of each denomination of certificates used in each city. Specimens should be accompanied by certificate and agreement of banknote company as specified under requirements for "Forms of Securities-Engraving" on page 14 hereof.

E. PROSPECTUS. One copy of the latest prospectus or offering circular, if any.

F. ANNUAL REPORT. One copy of the latest printed Annual Report distributed to stockholders.

G. OPINION OF COUNSEL. One copy of Opinion of Counsel as to the legality of organization of the applicant, the authorization for the issue and the validity of the securities applied for, whether the shares are fully paid and non-assessable, and whether personal liability attaches to ownership. If such counsel, or any partner of such counsel (or, if a firm, any member thereof) is an officer, director or stockholder of the issuing corporation, this fact must be disclosed in the opinion and in the listing application. Such opinion of counsel (or a separate opinion of counsel) shall set forth the basis of exemption from registration under the Securities Act of 1933 of the securities (or any portion thereof) applied for if such exemption is claimed.

H. MANAGEMENT. Certified list of officers and directors with the street address of each, the name and address of an individual banking reference of each, and a business history of each officer and director covering at least the past five years.

I. BONUS, PROFIT-PARTICIPATION, PENSION, AND RETIREMENT PLANS. One certified copy of each bonus, profit-participation, pension, retirement, or similar plan described in Item 14 of the listing application.

J. RESOLUTION, RE LISTING. Certified copy of resolution of Board of Directors, authorizing the filing of the listing application and designating the officer or officers authorized to sign documents or agreements relative thereto and (if requested) to appear before the Officials of the Exchange. A suggested wording is as follows:

"RESOLVED that application be made to the American Stock Exchange for the listing of _____ of this Corporation and that _____
(Amount and designation of security) (Name(s) of Officer(s))
_____ be authorized by the Corporation to sign said application, to make such changes therein, or in any documents or agreements relative thereto, as may be necessary to conform with requirements for listing, and to appear (if requested) before officials of said Exchange."

K. CERTIFICATE OF DISTRIBUTION. One copy, signed by an officer of the applicant, of certificate and schedule showing as of a recent date the distribution of the security applied for, prepared on the printed Listing Form K supplied by the Exchange.

L. LISTING AGREEMENTS. One copy of Agreement to conform to Rules and Regulations Applying to Companies listed with the Exchange, executed by an executive officer of the applicant on the printed Listing Form L supplied by the Exchange.

Canadian Corporations. Officers, directors, and/or controlling stockholders of Canadian corporations are required to submit a special agreement relating to the sale of their shareholdings, copies of which agreement will be furnished upon request.

M. QUESTIONNAIRE. One copy signed by an executive officer of the applicant corporation on the printed Listing Form M supplied by the Exchange. Also "Blue-Sky" Questionnaire (Listing Form M-Supplement), if applicable.

N. CONTRACT WITH APPLICANT. One copy of contract of applicant agreeing to apply for the listing of additional shares prior to issuance. (Use printed Listing Form N supplied by the Exchange.)

O. CONTRACT WITH TRANSFER AGENT. One copy of contract of each transfer agent relative to the issuance of additional shares. (Use printed Listing Form O supplied by the Exchange.)

P. CONTRACT WITH REGISTRAR. One copy of contract of each registrar relative to the registration of additional shares. (Use printed Listing Form P supplied by the Exchange.)

Q. LISTING FEE. Check drawn to the order of "American Stock Exchange." (See page 15 for computation of amount.)

R. PATENT ROYALTY AGREEMENTS, ETC. If the applicant or subsidiaries pay or receive any substantial royalties (or similar payments) in connection with patents, patent rights, licenses, processes, etc., and has furnished details of the agreements with respect thereto, as called for by Item 3(a) of the listing application proper, it should furnish as a supporting paper one certified copy of each such agreement.

OIL CORPORATIONS

Additional Information and Papers to be furnished

Application.

In addition to the information specified on pages 3 to 6, inclusive, applications for the original listing of the securities of corporations which own or operate oil or gas properties must include in the appropriate portion of such applications the following information:

3. HISTORY AND BUSINESS. Brief history of the applicant corporation from its inception to the date of the application, including any materially important developments or acquisitions, and the nature and results of any materially important reorganization.

4(a) PROPERTIES. A summarized description of oil lands of the applicant and subsidiaries. Separate description for developed and undeveloped properties.

Developed Properties. (1) Location (by appropriate groupings, such as states, counties, fields, etc.), (2) show, as to each grouping, total number of leases (or properties) and aggregate area, and (3) total number of producing wells and aggregate present daily settled production accruing to the applicant's net interest.

Undeveloped Properties. (1) Location (by appropriate grouping, such as states, counties, fields, etc.), (2) show, as to each grouping, total number of leases (or properties) and aggregate area, (3) statement as to properties in process of development, showing (a) number of wells now drilling and (b) amount of funds available or guaranteed for completion of development program, and (4) intentions with respect to properties not in process of development.

4(b) State proximity to marketing or transportation facilities.

4(c) If storage facilities are owned (1) describe and give capacity and location, and (2) amount and present value of oil stored.

4(d) If pipe lines are owned, describe and give connections, gauge, capacity, mileage and location.

4(e) If refineries are owned, describe and give capacity, acreage, number of employees, products and by-products.

Additional Papers To Be Submitted.

In addition to Papers A to R required of all applicants for listing (as specified on pages 7 to 9, inclusive) corporations which own or operate oil or gas wells must submit the following:

S. Report, of recent date, of qualified engineer, including estimate of recoverable reserves. The report shall be accompanied by a signed statement of the engineer's qualifications. (In certain cases the Exchange may require the submission of the report of a qualified independent engineer not in the regular employ of the company.)

MINING CORPORATIONS

Additional Information and Papers to be furnished

Application.

In addition to the applicable information specified on pages 3 to 6, inclusive, applications for the original listing of the securities of corporations which own or operate mines as a material part of their business should include in the appropriate portion of such applications the following information:

3. HISTORY AND BUSINESS. Brief history of the applicant corporation from its inception to the date of the application, including (a) date of acquisition of principal properties and consideration paid therefor, (b) area and location of properties and proximity to railroad or transportation facilities, (c) amount and cost of development and construction work done to date, (d) mill and smelter facilities, and (e) present development program, amount of developed ore, and (in the case of a producing mine) a tabulation showing output for each of the past three years in tons of ore mined and tons/pounds/ounces of finished product, overall mining and milling cost per ton of ore, and unit cost of finished product.

4(a). PROPERTIES. A summarized description of mineral and other lands of the applicant and subsidiaries, including (1) location, (2) total number of claims and aggregate area, (a) producing, and (b) non-producing. If properties comprise more than one group, describe each group separately. If any properties are not held in fee, so state and describe how held. Description of other (above-ground) physical assets or plants (mill/smelter), including number of buildings, nature and condition of equipment, capacity, etc.

4(b). ENGINEER'S REPORT. Details as to required contents of engineer's reports will be found under T below. In its application, the corporation must quote excerpts from the engineer's report as follows:

Developing (non-producing) properties. Include excerpts from engineer's report covering (1) geological description of country, (2) history of the workings, (3) estimate of size of ore body, (4) character, analysis, and average value of ore, (5) proposed method of treatment, (6) engineer's recommendations re development program and (7) estimate of engineer as to amount of additional funds which will be required to complete the development program as outlined, and estimate of the length of time required to complete such development program.

Developed (producing) properties. Include excerpts from engineer's report covering (1) geological description of country, (2) history of the workings, (3) size of ore body, (4) character, analysis and average value of ore, (5) method of treatment, (6) amount of ore reserves, etc.

Additional Papers To Be Submitted.

In addition to Papers A to R required of all applicants for listing (as specified on pages 7 to 9, inclusive) corporations which own or operate mines as a material part of their business must submit the following:

S. Supplement the summarized description of mining properties appearing under Item 4(a) in the listing application proper (see above) by furnishing the following:

A tabulated list of mineral and other lands (separate lists for producing and non-producing properties), each property designated by number or claim name, showing (1) acreage of each, (2) location of each, (3) whether patented or unpatented, and (4) whether owned in fee, controlled, or leased. If any property held under lease, specify terms. Submit separate lists for properties held directly and those held through subsidiaries.

T. Report, of recent date, of qualified engineer. The report shall be accompanied by a signed statement of the engineer's qualifications. (In certain cases the Exchange may require the submission of the report of a qualified independent engineer not in the regular employ of the company.) The report should cover (1) the actual physical condition of the property; (2) geological description of country; (3) history of the workings; (4) estimate of size of ore body; (5) character, analysis and average value of ore; (6) method of treatment; (7) output for at least past three years; (8) present development program; (9) amount of ore reserves; etc.

In addition, in the case of mines which are developing, the engineer's report must contain (1) recommendations re development program; (2) estimate as to amount of additional funds which will

be required to complete the development program as outlined, and (3) estimate of length of time required to complete such development program.

U. Attorney's opinion of title to all of the properties. Each property or mining claim must be specifically referred to by number or claim name corresponding to that included in the list submitted under Paper S or referred to in listing application.

PUBLIC UTILITY CORPORATIONS

Additional Information to be Included in Application

In addition to the applicable information specified on pages 3, 4, 5 and 6, applications for the original listing of securities of public utility corporations must include in the appropriate portion of such applications the following information:

4(a). The description of the business should include a description of the various services rendered by the system, proportionate gross revenue derived from each service, a general description of the territory and population served by each service. Indicate the number of customers, or meters in service, classifying them into residential, industrial or commercial, municipalities, etc. State the aggregate amount of kilowatt hours or cubic feet of gas sold annually for past five years and aggregate revenue derived from each service annually for each customer classification. State average and peak loads, and installed capacity, indicating whether figure given represents rated capacity or actual capacity. Describe, in general terms, interconnection facilities and arrangements for purchases or sales of electricity and gas.

4(b). FRANCHISES. Furnish a list of all material franchises and similar concessions held by the applicant or its subsidiaries, stating briefly the general effect of each, the date of expiration, and the payments required to be made thereunder. The statement required by this item should include franchises and concessions of the applicant and subsidiaries only insofar as materially important to the total enterprise.

ORIGINAL LISTING OF BONDS

Form and Content of Application (when short-form is used).

When the short-form listing application is used, incorporating the prospectus by reference, the application will, in ordinary cases, be limited to the same items called for in short form applications for stock issues as specified on page 3 of this pamphlet.

Applicants which follow the short-form procedure should reserve 600 copies of the prospectus for delivery to the printer for attachment to the final printed copy of the short-form listing application for distribution to the mailing list of the Exchange.

Form and Content of Application (when long-form is used).

An application for original listing of bonds shall recite, in substantially the order given below, the following:

1. The title page, showing

A. The name of the applicant, and when and where incorporated.

B. Full title of the issue proposed for listing.

C. Date of application and formal request for listing, specifying the amount and full title of the issue applied for, and statement that the issue applied for represents a valid, binding and legal obligation of the issuer, enforceable according to its terms.

2 to 20 inclusive. The same information called for by similar items of application for original listing of stock, if applicable, (see pages 4, 5 and 6) except that in lieu of Item 7 ("Stock Provisions") insert the following:

7(a) "Description of _____." Insert title of issue applied for and give in narrative form the following information: (1) title of instrument under which created, (2) dates of authorizations for issue, including directors, stockholders and public authorities, (3) date of issue and maturity, (4) interest rate, (5) places and date for payment of principal and interest, standard of money in which payable, (6) tax exemptions, (7) whether issuable in coupon or registered form, (8) denominations issuable, (9) whether exchangeable as between registered and coupon form, and interchangeable as to denominations, together with places and times at which exchange may be made, (10) where registerable and transferable.

7(b) "Indenture Provisions". Summarize the Indenture provisions of the issue applied for with respect to the following:

1. Security, describing the lien created by the indenture or other instrument, properties covered (in general terms), and other assets pledged thereunder. Describe also any underlying or prior liens.
2. Additional Issues, stating conditions under which additional amounts of indebtedness may be issued.
3. Sinking Fund.
4. Redemption and call, including date on which redeemable, prices, method of selection in event of partial redemption, duration and place of published notice, disposition of bonds redeemed.
5. Default, including events constituting default, remedies of bondholders, percentage of bonds necessary to direct or control Trustee's action in regard to default.

   The Committee may object to any provision in an indenture whereby a request or demand of the holders of more than 30% in principal amount of any series of bonds secured by such indenture is necessary to compel the Trustee to proceed with the enforcement of any remedy given by the indenture upon the occurrence of any event of default, subject, however, to the limitation that there is no objection to a provision by which the action of a majority in amount of such bonds will rescind any minority action.
6. Release of pledged property from lien, stating conditions under which pledged property may be released from lien of the indenture, or other property substituted for pledged property.
7. Convertibility.
8. Modification, stating extent to which indenture may be modified in any particular, and conditions under which it may be so modified.
9. Treatment of deposited funds, stating how funds deposited pursuant to the terms of the indenture are required to be held, whether deposit of funds operates to discharge the properties pledged from the lien of the indenture and whether deposit of funds for payment of principal, interest or redemption price operates to discharge the obligation of the issuer with respect thereto.
10. Summarize the more important covenants of the indenture.
11. Names and addresses of Trustee, Fiscal and Paying Agents, agents for registry, exchange and interchange of bonds.

Papers To Be Submitted in Support of Applications for Original Listing of Bonds.

Applicants with no securities previously listed on the Exchange should submit all supporting papers and exhibits specified on pages 7, 8 and 9 required of applicants for original listing of stock, except N, O and P, in lieu of which the additional papers I and J specified below should be submitted.

Applicants with securities previously listed on the Exchange should submit the following papers:

A. FINANCIAL STATEMENTS. As specified under A on page 7 hereof.

B. OPINION OF COUNSEL. One copy of Opinion of Counsel of satisfactory standing as to the legality of organization of the applicant, the authorization for the issue and the validity of the securities applied for. If such counsel, or any partner of such counsel (or, if a firm, any member thereof) is an officer, director or stockholder of the applicant, this fact must be disclosed in the opinion and in the listing application.

C. DISTRIBUTION SCHEDULE. Distibution schedule of the securities applied for prepared in accordance with the Exchange's Listing Form K(1) for bond issues, copy of which may be obtained upon request. If, as in the case of a coupon bond, distribution cannot be determined in the form called for by Listing Form K(1), the Exchange will accept the best available estimate as to the number of holders.

D. SPECIMEN SECURITY. One specimen of each denomination (both registered and bearer form) of security to be listed, accompanied by certificate and agreement of banknote company as specified on page 14 hereof under "Forms of Securities-Engraving".

E. PROSPECTUS. One copy of any prospectus which may have been issued (or which is proposed to be issued) relating to the securities proposed for listing.

F. RESOLUTION, RE LISTING. Certified copy of resolution of the board of directors authorizing listing. A suggested wording is as follows:

"RESOLVED that application be made to the American Stock Exchange for the listing of _____ of this Corporation and that _____
(Amount and designation of security) (Name(s) of Officer(s))
_____ be authorized by the Corporation to sign said application, to make such changes therein, or in any documents or agreements relative thereto, as may be necessary to conform with requirements for listing, and to appear (if requested) before officials of said Exchange."

G. QUESTIONNAIRE. Questionnaire signed by an officer of corporation. (Listing Form M may be obtained upon request.) Also "Blue-Sky" Questionnaire (Listing Form M-Supplement), if applicable.

H. LISTING AGREEMENTS. Execution and filing of the listing agreements (Listing Form L) will be required only if there has been a change in the standard form of agreements since the previous filing or if agreements previously omitted because inapplicable become applicable in connection with the current application, or if modifications are made in the standard agreements.

I. INDENTURE. One copy of the mortgage, indenture, or equivalent instrument, certified by Trustee.

J. TRUSTEE'S CERTIFICATE. A certificate from the Trustee showing: (a) acceptance of the trust, (b) that the securities have been issued in accordance with the terms of the indenture, (c) what disposition has been made of securities redeemed or refunded, (d) that pledged collateral has been deposited, and (e) what disposition has been made of prior obligations.

K. LISTING FEE. Check drawn to the order of "American Stock Exchange." (See page 15 for schedule.)

REQUIREMENTS FOR TRUSTEES FOR BOND ISSUES

Trustee to be a bank or trust company:

It is required that for an issue to be considered suitable for listing, the Trustee be a trust company or banking institution having substantial capital and surplus and the experience and facilities for handling corporate trust business. In cases where, for any reason, an individual has been appointed as trustee, a qualified trust company or banking institution must be appointed Co-trustee.

Separate trustee for each issue:

If the applicant, either at the time of listing or subsequently, should have bonds or other evidences of indebtedness outstanding under more than one mortgage, indenture or deed of trust, each issue shall be represented by a different Trustee.

Persons not acceptable as Trustees:

The Exchange will not regard as satisfactory to act as Trustees for listed issues (1) an officer or director of the issuing corporation; (2) a trust company, banking institution, or other organization in which an officer of the issuing corporation is an executive officer, or (3) any organization controlled by, under common control with, or which itself controls, the issuing corporation.

Changes in Trustees:

No change is to be made in the Trustee of a listed issue without prior approval of the Exchange. An agreement to that effect is included in the standard listing agreements which the applicant makes at the time of listing.

REQUIREMENTS FOR TRANSFER AND REGISTRY OF STOCK

Companies applying for the listing of a stock issue on the Exchange are required to agree to maintain in the New York City metropolitan area facilities for the transfer and registry of stock, as well as for conversions or exchanges of their listed securities.

Transfer and registry agencies may, of course, be maintained in other cities in addition to those maintained in the New York City metropolitan area. When shares are transferred in more than one transfer office, certificates shall be interchangeably transferable, and identical in color and form, except as to names of transfer agent and registrar; and the combined amounts of stocks registered in all transfer offices shall not exceed the amount authorized to be listed. Interchangeable certificates must bear a legend to that effect, specifying the cities in which they may be transferred.

One bank or trust company may act in the dual capacities of transfer agent and registrar, provided that it countersigns stock certificates in both capacities.

If a stock is transferred at the company's office, the transfer agent shall be appointed by specific authority of the board of directors to countersign certificates in that capacity, and shall be other than an officer who is authorized to sign certificates of stock. A company cannot act as registrar of its own listed stock, viz. if a listed stock is transferred at the issuing company's office, a separate registrar (bank or trust company satisfactory to the Exchange) must be maintained.

A change in the form of a security, of a transfer agency, or of a registrar, shall not be made without the approval of the Exchange.

FORMS OF SECURITIES—ENGRAVING

The following are the basic requirements of the Exchange subject to review of the forms of securities. It is suggested that proofs of the security be submitted to the Division of Securities prior to the final printing.

The face of listed securities in definitive form (stock and bonds) must be printed from at least one engraved steel border plate produced by a banknote company whose work is acceptable to the Exchange. The above is a minimum requirement—the company may at its option use a second steel engraved face plate.

The engraved border plate (and engraved face plate, if used) must be original to the banknote company which prepared the security, and the name of such banknote company must appear on the face of all securities and also on the face of coupons and filing panel of each bond.

The border plate shall remain in the permanent possession of the banknote company which produced it. The plate may be used by such banknote company in the production of "controlled stock" securities of more than one company, provided that such securities are prepared in their entirety in the premises of such banknote company, which shall furnish the Exchange with the certificate and agreement referred to below.

The printing of securities must be in distinctive colors, to make classes and denominations readily distinguishable.

All paper used for securities must be of an excellent grade of bond paper, of adequate weight and strong enough to withstand the strains and stresses of frequent handling. Stock certificates shall be of the standard size of 8 x 12 inches.

The Exchange prefers that stock certificates be issued in 100 share and less than 100 share denominations, but may approve the use of one certificate for all denominations subject to certain conditions.

If certificates of 100 share and less than 100 share denominations are used, it is recommended that provision be made for issuance of certificates for more than 100 shares for the convenience of large holders. The Exchange does not specify the form for the latter type of certificate and does not require acceptance of them by the purchasing broker in settlement of a contract made on the Exchange. Some companies which use certificates for more than 100 shares prepare a special certificate for the purpose and others alter the certificate for less than 100 shares by crossing out the denominational corner text and denominational panel with ink or by rubber stamp. In either case, the desired number of shares is usually entered on the certificate both by typewriter and by use of a macerating machine.

When shares are transferred in more than one transfer office, certificates shall be interchangeably transferable and identical in color and form, except as to names of transfer agent and registrar, and the certificates shall bear a legend naming all cities in which they may be transferred.

A change in the form of a security shall not be made without approval of the Exchange.

Specimens of the security in final form, printed on the bond paper used for the finished security, must be submitted to the Exchange accompanied by:

1. A certificate of the banknote company that

   (a) the security has been prepared in accordance with the printing and engraving requirements of the American Stock Exchange; and

(b) all work done in connection with the preparation and manufacture of the dies, rolls, plates and certificates has been and will be done entirely on the premises of the banknote company, except as may be specifically noted. If there are any exceptions, full details must be given.

2. An agreement by the banknote company (by its terms binding upon the banknote company, its successors and assigns) that all dies, rolls, plates and other engravings used in connection with the manufacture of certificates of the particular issue will, at all times, be and remain in the possession of the banknote company and, when not actually being used in connection with the manufacture and preparation of certificates, will be kept in a vault on the premises of the banknote company, and all completed certificates of the issue and all certificates in process will, prior to delivery to or upon the order of the issuing company (except when in actual process of manufacture), be kept in such vault.

LISTING FEES

Original Listing Applications:

Stock Issues—The original listing fees for stock issues (or long-term warrant issues, based upon the aggregate number of shares the warrants evidence the right to purchase) are as follows:

1¢ per share for first 250,000 shares, and

¼¢ per share for the balance of the shares included in the original listing application (either issued shares or unissued shares to be added to the list on notice of issuance) to a maximum of $5,000 on each original listing application. (If the number of shares applied for in the original listing application exceeds 1,250,000 shares, the maximum fee is applicable.)

Bond Issues—The original listing fees for bond issues are as follows:

$100 per million dollars ($1,000,000) face value, or fraction thereof. Maximum fee on each application $2,500, regardless of the number of bond issues (or the principal amount thereof) applied for in one original listing application. Minimum $500.

Continuing Annual Fee:

$250 per company, payable on September 1 of each year commencing September 1, 1962. The continuing annual fee shall only be charged to companies with listed stock or warrant issues. (No annual fee for companies with only bonds or similar issues listed.)

Supplemental Listing Applications:

Listing of additional shares subsequent to original listing—1¢ per share to a maximum of $2,500 for each application. (If amount applied for in any one application exceeds 250,000 shares, the maximum of $2,500 is applicable.) Minimum fee on each application $100. (If amount applied for is less than 10,000 shares, the fee is $100.)

"Substitution" Listings—In cases where, after original listing, a change is effected by charter amendment or otherwise under which

(a) shares listed upon the Exchange are changed or exchanged into the same or a lesser number of shares, either with or without a change in par value, the fee for the listing of such number of "new" substituted shares to be listed as is not in excess of the amount previously listed shall be ¼¢ per share to a maximum of $500.

(b) If the number of listed shares are increased, as in the case of a split-up, the full basic listing fee will be charged, i. e., 1¢ per share, to a maximum fee of $2,500 for all shares included in the application.

Reincorporation, Merger or Consolidation—If a listed corporation reincorporates, or merges or consolidates into, or with, a subsidiary or parent corporation or with one or more corporations which are neither the parents nor subsidiaries of the listed corporation, the "substitution" listing fee schedule (see above) is applicable.

PRINTING COSTS

In addition to the payment of listing fees, applicant corporations are required to pay the cost of printing the listing application, and will be billed directly by the printer.

REFUNDS OF LISTING FEES

Applications Withdrawn or Not Approved:

In the event a listing application is not approved by the Exchange, or withdrawn by the applicant, a service charge deduction of 25% (not to exceed $250) will be made by the Exchange from the listing fee as previously paid by the applicant, and the balance will be refunded to the applicant. In the event of the subsequent refiling of an application after such a service charge deduction has previously been made, such previous deduction will be applied as a credit to the listing fee payable in connection with the refiling of the application, with the understanding that in the event the application is again withdrawn or not approved a further service charge deduction, on the same basis as above outlined, will be made from the fee paid upon the occasion of the second filing. This procedure will be followed in the event of all further refilings.

Credits After Approval:

No cash refunds of listing fees will be made in any case where final action on applications has been taken, authorizing a listing. If additional unissued shares have been authorized for addition to the list "upon official notice of issuance" and all of such shares are not issued for the purpose for which listing authority was granted, a credit will be allowed (calculated as shown below) which may be applied in full or partial payment of fees payable in connection with future listing applications. In such cases, upon cancellation of listing authority for such number of shares as are no longer reserved for issuance for the purpose for which listing authority was granted, the company will acquire a credit for the fee paid upon the listing of such shares after deducting therefrom (a) the fee retained by the Exchange for the number of shares, if any, which were issued and added to the list under the same listing authorization, or (b) $250, whichever is greater. In connection with the cancellation of all listing authorizations the Exchange will be entitled to a minimum charge of $250 regardless of the number of shares issued.

[EXHIBIT H]

86 TRINITY PLACE
New York 6, N. Y.
Telephone REctor 2-0800

AMERICAN STOCK EXCHANGE

DIVISION OF SECURITIES

APPLICATIONS SUBSEQUENT TO ORIGINAL LISTING

These instructions are applicable to issuers of previously listed securities in the filing of subsequent applications, including applications for the listing of securities (stocks or bonds) of an issue, class or series not previously listed.

The instructions are also applicable to subsequent applications which are required in cases such as the following:

Prior to issuance of an additional amount of a listed security. (See note * below for stock dividend or split-up.)

Prior to effecting a change in a listed security which creates a new security or which alters any of the listed security's rights, preferences or terms, including proposed charter amendments under which shares listed upon the Exchange are to be split-up, change or exchanged into a greater or lesser number of shares, either with or without a change in par value. (See note * below for stock dividend or split-up.)

If, after authorization of listing of unissued securities upon notice of their issuance for a particular purpose, such purpose or its terms are materially changed.

Assumption of a listed security by another company.

Merger or consolidation into or with one or more corporations.

No subsequent listing application will be required in the case of a Charter amendment effecting a change in par value without changing the outstanding amount of a listed security, or a change in designation or other change which does not alter any of its rights, preferences, privileges or terms. In such cases the issuer corporations are required to file with the Exchange various papers evidencing the change, a memorandum of which will be furnished upon request.

*NOTE:

Stock Dividend or Split-up:—A simplified form of application is available for use in connection with applications to list additional shares (of a class previously listed) to be issued pursuant to a stock dividend or split-up only. Copies of such application form may be obtained upon request.

Stock Option or Stock Purchase Plans:—A simplified form of application is available for use in connection with applications to list additional shares (of a class previously listed) to be reserved for issuance pursuant to stock option or stock purchase plans. Copies of such application form may be obtained upon request.

STOCKHOLDERS' APPROVAL REQUIRED IN CERTAIN CIRCUMSTANCES

Reference is made to the statements appearing on page 10 hereof under the caption "Policies Relating to Applications Subsequent to Original Listing" which set forth certain types of transactions which require stockholders' approval as a prerequisite to approval of applications for the listing of additional shares issuable pursuant thereto.

TIME SCHEDULE

The Exchange considers supplemental listing applications every Tuesday. The listing application must be filed with and approved by the Exchange prior to the issuance of the additional amount, or the effective date of the change or modification of the previously listed security. Accordingly, the applications should be filed sufficiently early to permit action to be taken thereon in regular course. In the case of a proposed charter amendment under which a previously listed security is to be changed into a new security, the time schedule should be so arranged that the substitution of the new for the old security may be effected without any interruption of trading.

In any case in which the applicant is undertaking a commitment to issue securities by a certain date, or in which it is essential that a change in a listed security be effected by a certain date, or where it is otherwise essential that the securities be fully qualified for admission to trading by a

certain date, it is urged that the Division of Securities be consulted at the earliest possible moment in order that a satisfactory time schedule may be worked out. This is particularly important in cases where rights to subscribe are to be offered.

PROCEDURE

Each complete application for listing consists of the following:

(a) The application, signed by an executive officer of the corporation, and prepared in the form outlined on pages 3 to 6 of this pamphlet.

(b) The separate supporting papers specified on pages 6 to 9 of this pamphlet.

No prepared or blank forms are available for the listing application itself. The applicant prepares its own application, in typewritten narrative form, following the instructions as to the form and content thereof as outlined on pages 3 to 6 of this pamphlet. Applicants will find reference to a recently approved listing application of a type similar to their own of assistance in the preparation of their application, and the Division of Securities of the Exchange will furnish such specimen applications upon request. The employees of said department will also advise and assist in the preparation of applications to list whenever so requested.

Three preliminary typewritten drafts of the listing application (each copy signed by an executive officer of the applicant corporation) accompanied by financial statements in duplicate and one copy of each of the required supporting papers and documents, should be initially filed with the Division of Securities for examination. If, as the result of such examination, any deficiencies are noted, or any changes are considered necessary in the form or contents of the application and supporting papers, a list thereof will be furnished the representative of the applicant. After the corrected and additional data have been filed, the listing application proper is set up in the form of a printer's proof and is then ready for presentation to the Committee on Securities which meets every Tuesday.

The final draft of the listing application, in the form as signed and filed by the applicant (including therein the financial statements submitted by the applicant), will be printed as bulletins for distribution to members of the American Stock Exchange and others. Applicant corporations are required to pay the cost of printing the 600 copies required for this purpose, being billed directly by the printer.

REGISTRATION WITH THE SECURITIES AND EXCHANGE COMMISSION

If registration under the Securities Act of 1933 is required, such registration must be effective prior to the admission of the security to dealings on the Exchange. If such registration covers additional shares or amounts of a previously listed security the listing application should be filed with the Exchange during the period in which the Securities Act of 1933 registration is pending, so that the additional amount may be authorized for listing in advance of (and subject to) the effectiveness of such registration. In such cases a short-form listing application (see below) would be filed with copies of the preliminary (red-herring) prospectus.

No registration application under the Securities Exchange Act of 1934 on Form 8-A, or otherwise, is required to be filed with the Securities and Exchange Commission for additional shares or amounts of a previously listed and registered security, pursuant to the amendments of the Commission's rules (particularly Rule X-12D1-1) effective January 28, 1954. If the application covers the listing of an issue, class or series of a security (of the same issuer) which has not been previously listed, an application (usually on Form 8-A) must be filed and registration under the Securities Exchange Act of 1934 must be effective before the new security may be admitted to dealings on the Exchange.

SHORT-FORM LISTING APPLICATION INCORPORATING PROSPECTUS OR PROXY STATEMENT BY REFERENCE

A simplified procedure is permitted in respect of listing applications if a prospectus relating to the securities applied for is in process of issuance or has been issued in accordance with the requirements of the Securities Act of 1933 within a reasonably short period prior to the date on which the listing application is filed. In such cases, at the option of the applicant, any of the data required in the listing application may be furnished by reference to the prospectus. Where this is done, the prospectus shall be attached to and made part of the listing application, which will refer specifically to those parts of the attached prospectus which are being incorporated by reference. The listing application itself shall contain all required data not included in the prospectus. In ordinary cases, such short-form listing applications are limited to Items 1 to 6 inclusive, 13 and 15 of the information required in long-form applications as out-

lined below, and an additional item titled "Prospectus" is inserted, referred to and incorporating the prospectus by reference, and indexing the information contained therein.

The above procedure is also permitted in cases where a proxy statement, prepared in accordance with the proxy rules (Regulation X-14) of the S. E. C., is available, describing the transaction pursuant to which the securities applied for are to be issued.

Applicants which follow this procedure should reserve 600 copies of the prospectus (or proxy statement) for delivery to the printer for attachment to the final printed copy of the short-form listing application, for distribution to the mailing list of the Exchange. Applicants which use the short-form application should also submit all of the supporting papers and exhibits specified on pages 5 and 6 below.

SIMPLIFIED APPLICATION FORM

Where a company has followed the practice of disclosing to the public through its annual reports or otherwise the data that would be required to be set forth in the application a simplified form may generally be used that would require only the data called for under Items 1 to 6, inclusive, 13 and 15 of the information required in long-form applications as outlined below, and an additional item titled "Recent Developments" should be inserted stating whether there have been any important developments affecting the company or its business since the latest annual report of the company which have not received publicity. If so, describe such developments.

FORM AND CONTENT OF APPLICATION APPLICABLE TO STOCKS AND BONDS

(When short-form is not used)

The listing application is designed to give all pertinent information as to the event which leads to its filing, whether that be the issuance of an additional amount of a listed security, or a change in the terms of a listed security, or a change in purpose of issuance, etc., and, in addition, to bring up to date information concerning the applicant and its securities given in previous applications.

The application (three typewritten copies of which should be submitted) shall recite, in substantially the order given below, the following:

1. TITLE PAGE showing

(a) The name of the applicant, and when and where incorporated.

(b) The full title or designation of the security proposed for listing.

(c) Date of application and formal request for listing, specifying the amount and title of the security applied for, and (in the case of stock issues) the par value and whether the security is fully paid and non-assessable, and whether personal liability attaches to ownership.

Application shall be made to list unissued securities only if they have been authorized for issuance for a specific purpose. The request for listing should state briefly, but specifically, the purpose of issuance, and the authorization for listing is effective only if the securities are issued for that purpose.

2. CAPITALIZATION. In tabulated form, the following: (1) designation or title of each class of stock, (2) par value, (3) number of shares (a) authorized by charter, (b) authorized for issuance (including unissued reserved shares), (c) outstanding, and (d) applied for.

As a footnote to "Capitalization", insert tabulation showing number of unissued shares of each class of stock reserved for issuance for any purpose, and purpose for which reserved. If no unissued shares reserved for issuance for any purpose except the shares applied for so state.

3. FUNDED OR LONG-TERM DEBT. In tabulated form, show, for each issue or series of funded or long-term debt of the applicant and subsidiary or controlled companies, the following: (1) full title (including interest rate and maturity date), (2) amount authorized by indenture, (3) amount issued to date, (4) amount redeemed, and (5) amount outstanding. If none, so state.

4. AUTHORITY FOR AND PURPOSE OF ISSUANCE. State the date(s) of meetings of directors (and stockholders if such is the case) at which issuance of the securities applied for was authorized, and date of any certificate, order or proceedings of any public authority having jurisdiction.

In the case of acquisitions refer (by date and names of parties thereto) to the contract pursuant to which the securities will be issued and state that a copy of such contract has been submitted in support of the listing application.

(a) **Mergers, consolidations, modifications of previously listed securities, etc.:**

Ordinarily transactions of this nature will be covered by a proxy statement to be attached to the listing application, so that only a statement of the dates of authorization by directors and stockholders will be required (see above), and reference will be made to the proxy statement for further details. If modification of a previously listed security is not covered by a proxy statement attached to the listing application, describe the nature and effect of the proposed modification, and the basis of exchange.

(b) **Sales for Cash:**

If an additional amount of a previously listed security is to be registered under the Securities Act of 1933 and issued for cash pursuant to a public offering, ordinarily only a statement of the date(s) of authorization by directors (and stockholders if such is the case) will be required, and reference will be made to the prospectus for further details.

If the securities are to be sold in a private transaction, without registration under the Securities Act of 1933, include a summary of all important provisions of the contract of sale. State the net proceeds to be received, and the per-unit market price of the outstanding securities of the same class at the time the transaction was authorized. State the number of purchasers, and whether any of them has any affiliation with management. Submit a separate letter showing names and addresses of purchasers and amount to be purchased by each.

(c) **Shares Reserved for Conversion:**

If application is made for the listing of an additional amount of a previously listed security reserved for issuance in conversion of another security, describe the transaction of issuance of the other security, the conversion rate, etc. State the per unit market price (of the class reserved for conversion) at the time the transaction was authorized in relationship to the conversion price.

(d) **Acquisitions:**

If the securities applied for are to be issued as the total or part of the consideration for the acquisition of

a controlling interest in, or the major part of the business and assets of, another company, or

specific assets or properties,

(1) describe the transaction, and the assets or business to be acquired, in sufficient detail to indicate the relative value thereof in relationship to the consideration to be paid;

(2) state the principle followed, and the factors considered, in determining the consideration to be paid in the acquisition, and identify the persons making the determination and their relationship to the applicant;

(3) state why the management of the applicant regards the acquisition as a favorable one from its viewpoint.

State whether or not any officer, director or principal stockholder of the applicant (or any of its affiliates) has any direct or indirect beneficial interest in the assets to be acquired or the consideration to be paid and, if such interest does exist, describe it. (See requirement for a vote of stockholders with respect to certain acquisitions on page 10 of this pamphlet.)

If a controlling interest in, or the major part of the business and assets of, another company is being acquired, describe briefly the history and business of such other company, and furnish financial statements of such other company as called for under Paper A(1) on page 7 hereof.

If any engineering, geological or appraisal reports, etc. were obtained in connection with the proposed acquisition, refer to such reports and include appropriate excerpts therefrom in the listing application.

Accounting Treatment:

Describe the accounting treatment to be accorded the transaction on the books of the company, and in consolidation. In the case of acquisitions state whether the transaction will be treated as a "purchase" or a "pooling of interests". State the policy to be followed with respect to amortization whenever intangible assets are acquired or created. Where other than routine transactions such as issue of securities for cash, etc. are involved, the accounting treatment should be reviewed with the company's independent accountants and a statement should be made that they have reviewed and

approved such accounting treatment as being in accordance with generally accepted accounting principles.

5. OPINION OF COUNSEL. State the name and address of counsel rendering the opinion filed in support of the application. If such counsel, or any partner of such counsel (or, if a firm, any member thereof) is an officer, director or stockholder of the applicant, this fact must be stated.

6. REGISTRATION UNDER SECURITIES ACT OF 1933. State whether securities applied for (or any portion thereof) are registered under Securities Act of 1933. If securities (or any portion) are not so registered, a statement must be made that legal opinion has been received that registration is not required. Indicate the section of said Act as the rule of the Commission under which exemption from registration is claimed, and the basis of such exemption. If exemption is claimed under section 4(1) of said Act state whether or not the shares will be acquired for investment by the recipients thereof.

(Note: When short-form application is used, incorporating prospectus or Proxy Statement by reference, Items 1 to 6 inclusive above, and 13 and 15 below would ordinarily be the only items as to which information is required, in addition to which an additional item titled "Prospectus" (or "Proxy Statement") should be inserted in the application, referring to and incorporating the prospectus (or Proxy Statement) by reference and indexing the information contained therein.)

7. BUSINESS AND OPERATIONS. State whether or not there has been a material change in the nature of the applicant's business or that of its subsidiary or controlled companies since the date of the last application.

Describe any important developments which may have occurred in the business since the date of the last application or in the last three years (whichever period is shorter), and for the same period state the annual output (in terms of physical units if practicable, otherwise in dollars).

State number of employees.

8. PROPERTIES. State what major changes have occurred in the properties of the applicant and its subsidiary or controlled companies since the date of the last application. If so desired, the property description may be entirely restated pursuant to the instructions for an original listing application, in lieu of description of the changes.

9. SUBSIDIARY AND AFFILIATED COMPANIES. State what changes there have been in the applicant's holdings in all subsidiary, controlled or affiliated companies since the date of the last listing application. If so desired, the applicant's present holdings may be restated pursuant to the instructions for an original listing application.

10. DIVIDEND RECORD. State the amount of dividends paid each year since the date of the previous application, or for the last five years, whichever period is the shorter. The amount should be shown per share and in the aggregate. Show stock dividends separately.

The aggregate and per share amounts of dividend arrearages, if any, should also be stated.

11. CHANGES IN CAPITALIZATION. State what changes have occurred in authorized stock capitalization since the date of the previous listing application.

State what changes have occurred in the amounts of stock outstanding since the date of the last listing application, or within the last three years (whichever period is shorter), and the consideration received for any shares issued during such period.

12(a). STOCK PROVISIONS. If the application is for the listing of a class of stock not previously listed, include a summarized statement of its rights, preferences, privileges and priorities and of each class on a parity with or senior to it.

12(b). DESCRIPTION OF BONDS. If the application is for the listing of an issue or series of bonds not previously listed, give, in narrative form under the caption "Description of (title)" the following information:

(1) Full title of issue, (2) Title of instrument under which created, (3) Name of Trustee, (4) Dates of authorizations for issue, including directors, stockholders and public authorities, (5) Amount authorized, amount issued to date, amount retired, amount outstanding, (6) Date of issue and maturity, (7) Interest rate, (8) Places and dates for payment of principal and interest and standard of money in which payable, (9) Tax exemptions, (10) whether issuable in coupon

or registered form, (11) Denominations issuable, (12) Whether exchangeable as between registered and coupon form, and interchangeable as to denominations, together with places and times at which exchanges may be made, and (13) Where registerable and transferable.

12(c). INDENTURE PROVISIONS. If the application is for the listing of a bond issue not previously listed, summarize the indenture provisions with respect to the following:

1. Security, describing the lien created by the indenture or other instrument, properties covered (in general terms), and other assets pledged thereunder. Describe also any underlying or prior liens.
2. Additional issues, stating conditions under which additional amounts of indebtedness may be issued.
3. Sinking Fund.
4. Redemption and call, including date on which redeemable, prices, method of selection in event of partial redemption, duration and place of published notice, disposition of bonds redeemed.
5. Default, including events constituting default, remedies of bondholders, percentage of bonds necessary to direct or control Trustee's action in regard to default.
6. Release of pledged property from lien, stating conditions under which pledged property may be released from lien of the indenture or other property substituted for pledged property.
7. Convertibility.
8. Modification, stating extent to which indenture may be modified in any particular, and conditions under which it may be so modified.
9. Treatment of deposited funds, stating how funds deposited pursuant to the terms of the indenture are required to be held, whether deposit of funds operates to discharge the properties pledged from the lien of the indenture and whether deposit of funds for payment of principal, interest or redemption price operates to discharge the obligation of the issuer with respect thereto.
10. Summarize the more important covenants of the indenture.

13. GENERAL INFORMATION. Under this caption state:

(a) Date on which fiscal year ends.

(b) Address of principal executive office of the applicant.

(c) Date and place of annual stockholders' meeting. State what percentage of voting stock constitutes a quorum.

(d) Names and addresses of all directors.

(e) Names and titles of all officers.

(f) Names and addresses of Transfer Agent and Registrar (if listing of stock is applied for), or names and addresses of Trustee, Fiscal and Paying Agents, agents for registry, exchange and interchange (if listing of bonds is applied for).

14. FINANCIAL STATEMENTS. Specify what financial statements are being submitted (separately) as an essential part of the listing application (See Paper A, page 7).

15. CERTIFICATE. Certificate and signature of duly authorized officer of the applicant corporation.

Supporting Papers to be Filed with Applications Subsequent to Original Listing

These papers are considered a part of the application and it is the policy of the Exchange to make them available for public inspection at the office of the Exchange upon request after the listing application is approved.

Required Papers.

The following is a list of the papers required to be filed in support of the application:

A. (1) FINANCIAL STATEMENTS OF ACQUIRED COMPANY:

If the securities for which listing application is made are to be issued in connection with the acquisition of a controlling interest in another company, or the acquisition of all the assets, subject to liabilities, of another company, there shall be submitted, in duplicate, the balance sheet, of such company at recent date and its income account and surplus account to the date of such balance sheet. Usually these shall be the most recent annual financial statements, supplemented by the latest available interim statements. Such statements should be certified by independent auditors, but in cases where independently certified financial statements are not available statements certified to by the chief accounting officer of such other company may be accepted. The financial statements of acquired companies will be printed at the end of the listing application.

A. (2) FINANCIAL STATEMENTS OF APPLICANT COMPANY:

Applicants which use the short-form listing application incorporating a prospectus or proxy statement by reference will not, in ordinary circumstances, be required to submit additional financial statements unless those in the prospectus or proxy statement are prepared as of and to a date more than six months prior to the date of the listing application. In such event the supplementary financial statements referred to below should be submitted.

If the applicant does not use the short-form listing application, two copies of its annual report to stockholders for its latest fiscal year should be furnished. If the independently audited financial statements contained in such annual report are more than six months old, the applicant should also submit the supplementary financial statements referred to below.

Supplementary Financial Statements:

If the independently certified financial statements of the applicant for the past fiscal year, filed with the American Stock Exchange are as of and to a date more than 6 months prior to the date of the listing application, such statements shall be supplemented by corresponding statements, similar in form and content, as of and to a date not more than 6 months prior to the date of the listing application, which supplementary financial statements will, in ordinary cases, be accepted either (a) independently certified, or (b) certified by the chief accounting officer of the applicant corporation. Such interim statements should be submitted in duplicate.

The interim statements should carry appropriate footnotes generally equivalent, if applicable, to the footnotes to the independently audited statements as of and to the previous fiscal year end, but revised and amplified to cover any changes therein since the last fiscal year end. If desired, a statement may be made referring to and incorporating by reference the notes to the audited financial statements for the previous fiscal year end, and specifying that such notes are applicable to the interim statements "subject to" (specify any changes or additions therein since the date of the last fiscal year end).

Financial statements of acquired companies will be printed in the listing application. The American Stock Exchange will determine in each case whether it shall be necessary to print the financial statements of applicant companies in the listing application.

B. (1) One copy of each contract, plan or agreement pursuant to which the additional securities applied for are to be issued.

B. (2) If the securities applied for are to be issued in acquisition of a stock interest in another company, or properties or other assets, furnish one copy of any engineering, geological or appraisal report which may have been obtained in connection with the proposed acquisition.

C. OPINION OF COUNSEL. Opinion of counsel of satisfactory standing as to the legality of the authorization of issuance, validity of the security applied for. If shares are applied for, the opinion should also state whether they are fully paid and non-assessable, and whether personal liability attaches to ownership. If such counsel, or any partner of such counsel (or, if a firm, any member thereof) is an officer, director or stockholder of the issuing corporation, this fact must be disclosed in the opinion and in the listing application. (NOTE: If the security applied for is not being registered under the Securities Act of 1933, an additional opinion of counsel as to the reasons for such non-registration must also be furnished in answer to Item 11 of Listing Form M.

D. RESOLUTIONS: Certified copy of each of the following resolutions:

Resolution of the stockholders authorizing issuance (if corporate procedure required such action) with respect to any unissued securities for which listing application is made;

Resolution of Board of Directors authorizing issuance with respect to any unissued securities for which listing application is made;

Resolution of the board of directors authorizing listing. A suggested wording is as follows:

"RESOLVED that application be made to the American Stock Exchange for the listing of _____ of this Corporation and that _____
(Amount and designation of security) (Name(s) of Officers(s))
_____ be authorized by the Corporation to sign said application, to make such changes therein, or in any documents or agreements relative thereto, as may be necessary to conform with requirements for listing, and to appear (if requested) before the Committee on Securities of said Exchange."

E. QUESTIONNAIRE. Questionnaire (Listing Form M) signed by an officer of corporation. (Copies of Listing Form M accompany this pamphlet. Additional copies may be obtained upon request.) Also "Blue-Sky" Questionnaire (Listing Form M-Supplement), if applicable.

F. LISTING FEE. Check drawn to the order of "American Stock Exchange." (See page 9 for computation of amount.)

Additional Required Papers. (If applicable.)

F. AMENDMENTS TO CHARTER. One copy of each amendment to the charter not previously filed with the Exchange, certified by the Secretary of State or corresponding authority of the State of incorporation. If desired, there may be filed in lieu of such amendments one certified copy of the charter as amended to date.

G. AMENDMENTS to BY-LAWS. One copy of each amendment to the by-laws not previously filed with the Exchange, certified by an officer of the corporation. If desired, there may be filed in lieu of such amendments one certified copy of the by-laws as amended to date.

H. PROSPECTUS. One copy of any prospectus which may have been isuued (or which is proposed to be issued) relating to the securities proposed for listing.

I. LISTING AGREEMENTS. Execution and filing of the listing agreements (Listing Form L) will be required only if there has been a change in the standard form of agreements since the previous filing or if agreements previously omitted because inapplicable become applicable in connection with the current application, or if modifications are made in the standard agreements.

J. STOCK CERTIFICATES. If the form of stock certificate for the listed class of stock has been or is to be changed furnish one specimen of each denomination of the changed form, with certificate of the banknote company that the security has been prepared in accordance with the printing and engraving requirements of the American Stock Exchange.

Additional Papers Required if the Application Covers a Class of Stock Not Previously Listed.

J. STOCK CERTIFICATES. One specimen of each denomination of stock certificate of class to be listed, with certificate of the banknote company that the security has been prepared in accordance with the printing and engraving requirements of the American Stock Exchange.

K. CERTIFICATE OF DISTRIBUTION. One copy, signed by an officer of the applicant corporation, of certificate and schedule showing as of a recent date the distribution of the security applied for, prepared on the printed form supplied by the Exchange. (Copies of printed Listing Form K may be obtained upon request.)

N. CONTRACT WITH APPLICANT. One copy of contract of applicant corporation agreeing to apply, prior to issuance, for the listing of additional shares in excess of the amount applied for in present application. (Listing Form N may be obtained upon request.)

O. CONTRACT WITH TRANSFER AGENT. One copy of contract of each transfer agent relative to the issuance of additional shares in excess of the amount applied for in present application. (Listing Form O may be obtained upon request.)

P. CONTRACT WITH REGISTRAR. One copy of contract of each registrar relative to the registration of additional shares in excess of the amount applied for in present application. (Listing Form P may be obtained upon request.)

Additional Papers Required if the Application Covers an Issue or Series of Bonds not Previously Listed.

J. SPECIMEN BONDS OR NOTES. One specimen of each denomination (both registered and bearer form) of security to be listed, with certificate of the banknote company that the security has been prepared in accordance with the printing and engraving requirements of the American Stock Exchange.

K. DISTRIBUTION SCHEDULE. One copy, signed by an officer of the applicant corporation, of schedule showing as of a recent date the distribution of the security applied for, prepared on the printed form supplied by the Exchange. (Copies of printed Listing Form K (1) may be obtained upon request.) If, as in the case of a coupon bond, distribution cannot be determined in the form called for by Listing Form K (1), the Committee will accept the best available estimate as to the number of holders.

L. INDENTURE. Copy of the mortgage, indenture or equivalent instrument, certified by Trustee.

M. TRUSTEE'S CERTIFICATE. A certificate from the Trustee showing: (a) acceptance of the trust; (b) that the securities have been issued in accordance with the terms of the indenture; (c) what disposition has been made of securities redeemed or refunded; (d) that pledged collateral has been deposited; and (e) what disposition has been made of prior obligations. If an additional amount of a listed issue is applied for there shall be filed a certificate of the trustee covering items (b), (c), (d) and (e) above.

LISTING FEES

Original Listing Applications:

Stock Issues—The original listing fees for stock issues (or long-term warrant issues, based upon the aggregate number of shares the warrants evidence the right to purchase) are as follows:

1¢ per share for first 250,000 shares, and

¼¢ per share for the balance of the shares included in the original listing application (either issued shares or unissued shares to be added to the list on notice of issuance) to a maximum of $5,000 on each original listing application. (If the number of shares applied for in the original listing application exceeds 1,250,000 shares, the maximum fee is applicable.)

Bond Issues—The original listing fees for bond issues are as follows:

$100 per million dollars ($1,000,000) face value, or fraction thereof. Maximum fee on each application $2,500, regardless of the number of bond issues (or the principal amount thereof) applied for in one original listing application. Minimum $500.

Continuing Annual Fee:

$250 per company, payable on September 1 of each year commencing September 1, 1962. The continuing annual fee shall only be charged to companies with listed stock or warrant issues. (No annual fee for companies with only bonds or similar issues listed.)

Applications Subsequent to Original Listing:

Listing of additional shares (of the same class) subsequent to original listing—1¢ per share for shares in excess of amount previously listed to a maximum of $2,500 for each application. (If amount applied for in any one application exceeds 250,000 shares, the maximum of $2,500 is applicable.) Minimum fee on each application $100. (If amount applied for is less than 10,000 shares, the fee is $100.)

Listing of securities (stocks or bonds) of an issue, class or series not previously listed—The schedule for original listing (see above) will be applicable.

"Substitution" Listings—In cases where, after original listing, a change is effected by charter amendment or otherwise under which

(a) shares listed upon the Exchange are reclassified, changed or exchanged into the same or a lesser number of shares, either with or without a change in par value, the fee for the listing of such number of "new" substituted shares to be listed as is not in excess of the amount previously listed shall be ¼¢ per share to a maximum of $500.

(b) If the number of listed shares are increased, as in the case of a split-up, the full basic listing fee will be charged, i.e., 1¢ per share, to a maximum fee of $2,500 for all shares included in the application.

Reincorporation, Merger or Consolidation—If a listed corporation reincorporates, or merges or consolidates into, or with, a subsidiary or parent corporation or with one or more corporations which are neither the parents nor subsidiaries of the listed corporation, the "substitution" listing fee schedule (see above) is applicable.

PRINTING COSTS

In addition to the payment of listing fees, applicant corporations are required to pay the cost of printing the listing application, and will be billed directly by the printer.

REFUNDS OF LISTING FEES

Applications Withdrawn or Not Approved:

In the event a listing application is not approved by the Exchange, or withdrawn by the applicant, a service charge deduction of 25% (not to exceed $250) will be made by the Exchange from the listing fee as previously paid by the applicant, and the balance will be refunded to the applicant. In the event of the subsequent refiling of an application after such a service charge deduction has previously been made, such previous deduction will be applied as a credit to the listing fee payable in connection with the refiling of the application, with the understanding that in the event the application is again withdrawn or not approved a further service charge deduction, on the same basis as above outlined, will be made from the fee paid upon the occasion of the second filing. This procedure will be followed in the event of all further refilings.

Credits After Approval:

No cash refunds of listing fees will be made in any case where final action on applications has been taken, authorizing a listing. If additional unissued shares have been authorized for addition to the list "upon official notice of issuance" and all of such shares are not issued for the purpose for which listing authority was granted, a credit will be allowed (calculated as shown below) which may be applied in full or partial payment of fees payable in connection with future listing applications. In such cases, upon cancellation of listing authority for such number of shares as are no longer reserved for issuance for the purpose for which listing authority was granted, the company will acquire a credit for the fee paid upon the listing of such shares after deducting therefrom (a) the fee retained by the Exchange for the number of shares, if any, which were issued and added to the list under the same listing authorization, or (b) $250, whichever is greater. In connection with the cancellation of all listing authorizations the Exchange will be entitled to a minimum charge of $250 regardless of the number of shares issued.

POLICIES RELATING TO APPLICATIONS SUBSEQUENT TO ORIGINAL LISTING

In connection with the following policies pursuant to which stockholders' approval is required as a prerequisite to the listing of new or additional securities of a listed company, the minimum vote which will constitute stockholder approval for listing purposes is defined as "approval by a majority of votes cast on a proposal in a proxy bearing on the particular matter, provided that the total vote cast on the proposal represents over 50% in interest of all securities entitled to vote on the proposal."

Options to Officers, Directors or Key Employees:

Approval of stockholders will be required as a prerequisite to approval of applications to list additional shares reserved for options granted or to be granted to officers, directors or key employees, regardless of whether or not such authorization is required by law or by the Corporation's charter. The Exchange requires that such stockholders' approval will be solicited pursuant to a proxy statement

conforming to the proxy rules of the Securities and Exchange Commission which will disclose all of the essential details of the options or of the plan pursuant to which the options will be granted. This policy does not preclude the adoption of a stock option plan, or the granting of options, subject to ratification by stockholders prior to the filing of an application for the listing of the shares reserved for such purpose. The Exchange may not require stockholders' authorization of options in cases (a) where options are issued to an individual, not previously employed by the Corporation, as an inducement essential to his entering into a contract of employment with the Corporation, and (b) where options are issued under a plan in which all, or substantially all, of the Corporation's employees participate, depending upon the maximum amount issuable to any one individual under the plan and the proportionate distribution contemplated by the plan.

Stockholders' Approval of Acquisitions in certain circumstances:

Approval of stockholders will be required as a prerequisite to approval of applications to list additional shares to be issued as a sole or partial consideration for an acquisition of the stock or assets of another company in the following circumstances:

(a) If any director, officer or substantial stockholder of the listed company has an interest, directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction.

(b) If the acquisition will result directly or indirectly in an increase of 20% or more in the number of outstanding shares of the listed class of stock (including for the purpose of this calculation any shares issuable in conversion of convertible securities issued in the transactions).

(c) If the market value of the additional shares to be issued plus the fair value of any other consideration to be paid in the transaction equals 20% or more of the aggregate market value of the outstanding shares of the listed class of stock.

Acquisition of a Listed Company by an Unlisted* Company:

The Exchange will not approve an application to list additional shares of a listed company (or shares of a different surviving company) in any combination of a listed company with an unlisted company which, in the opinion of the Exchange, would result in the acquisition of the listed company by the unlisted company, unless the company resulting from the combination meets the original listing standards of the Exchange. The type of combination to which this policy relates is a so-called "back-door" listing generally resulting from a plan of acquisition, merger or consolidation the net effect of which is that a listed company is acquired by an unlisted company, regardless of which company is the survivor in the combination. In applying this policy consideration will be given to all relevant factors, including the proportionate amount of the securities of the resulting company to be issued to each of the combining companies, changes in ownership or management of the listed company, whether the unlisted company is larger than the listed company, the nature of the businesses being combined, etc.

The Exchange recommends that any proposed plan of the above nature, including particularly any plan under which stockholders of the listed company would own less than 50% of the shares or voting power of the resulting company, be submitted for an informal opinion before its promulgation.

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* The above reference to "unlisted companies" refers primarily to companies with no stock issues dealt in on the Exchange, but also includes companies with stock issues admitted to unlisted trading privileges on the Exchange.

[EXHIBIT I]

AMERICAN STOCK EXCHANGE
86 TRINITY PLACE,
NEW YORK 6, N. Y.
TELEPHONE REctor 2-0800

APPLICATION TO LIST ADDITIONAL SHARES (OF A CLASS PREVIOUSLY LISTED) TO BE ISSUED PURSUANT TO A STOCK DIVIDEND OR SPLIT-UP

.....
(Name of Issuer)

.....
(Class of Stock and Par Value)

.....
(City and Date)

..... hereby applies to the American Stock
(Name of Issuer)

Exchange for the listing upon official notice of issuance of the following:

(State number of shares, class of stock and par value, and that shares are to be issued in payment of a ....% stock dividend or pursuant to a (rate) split-up.)

The number of shares of said ..... Stock previously authorized for listing on the
(Class)
American Stock Exchange is .....

The number of shares of said ..... Stock now outstanding is .....
(Class)

UNISSUED RESERVED SHARES

Are any other unissued shares of the above class of stock (in addition to the shares herein applied for) now reserved for issuance for any purpose? ..... If so, furnish below details as to each block of stock reserved for a different purpose, and state as to each block, whether shares have heretofore been authorized for listing.

Number of Shares	Purpose for Which Reserved

This application has been executed by me pursuant to due authorization by the Board of Directors of the Corporation.

.....
(Name of Corporation)

By .....
(Title)

Address of principal executive offices of the Corporation: .....

Name and address of Registrar(s): .....

Split-ups or Stock Dividends on Lower Priced Issues:

Attention is called to the following statement of policy adopted and announced by the American Stock Exchange on April 5, 1962:

"The Exchange does not view favorably a split-up of a stock selling in a low price range or a split-up or substantial stock dividend which may result in an abnormally low price range for the shares after the split or stock dividend. Any company considering a split-up *(or a stock dividend of more than 5%)* which would result in an adjusted price of less than $7.50 per share for its stock should consult with the Division of Securities of the Exchange in advance of taking formal action."

EXHIBITS

The following papers shall accompany the application:

1. Opinion of Counsel of the issuer that the additional shares to be issued (specify amount and purpose of issuance) have been duly and validly authorized for issuance, and, when issued, will be fully paid and non-assessable, with no personal liability attaching to ownership thereof.

2. Listing Form L (Listing Agreements).

   Execution and filing of the listing agreements will be required only if there has been a change in the standard form of agreements since the previous filing.

3. Listing Fee.

   Check drawn to the order of "American Stock Exchange" computed as follows:

   (a) In the case of a stock dividend or a split-up:

   1¢ for each share applied for in excess of the amount previously listed with a maximum charge of $2,500 (i. e., if the additional amount applied for exceeds 250,000 shares, the fee is $2,500 regardless of the amount of shares). Minimum fee on each additional listing application $100 (if amount applied for is less than 10,000 shares).

   (b) Substitution of "new" shares in lieu of "old" shares pursuant to a "reverse split":

   (i) ¼¢ per share for the number of "new" shares listed, to a maximum fee of $500.

4. Charter Amendment.

   If the charter (articles of incorporation) has been or is to be amended, furnish one copy of such amendment certified as to filing by the Secretary of State or corresponding authority of the State of incorporation. If the amendment has not as yet been filed, furnish such certified copy as soon as available.

5. Stock Certificates.

   If the form of stock certificates of the listed class of stock has been or is to be changed, furnish one specimen of each denomination of the changed form.

(See Instructions on page 4)

INSTRUCTIONS

A. Under the caption "Authority For and Purpose of Issue" recite the following:

(1) Date of meeting of Board of Directors at which the issuance of the shares applied for was authorized and (in the case of a split-up which requires stockholder action and a charter amendment, etc.) date when meeting of stockholders has been or will be held, and date charter amendment will be filed.

(2) The rate (or %) of the stock dividend or split-up, and, in the case of a stock dividend (or split-up to be effected by mailing certificate) the record and payment dates of such distribution.

(3) Treatment of Fractional Amounts:

State method of handling fractional amounts. If cash is to be paid in lieu of fractional shares or scrip, state the amount per share upon which such payment will be predicated and the basis of determining that amount (i.e. based on the last sale on the record date, or whatever other basis may be used). If scrip certificates are to be issued, state details, including expiration date, etc.

(4) Accounting Treatment For Stock Dividend or Split-up:

State changes effected or to be effected in connection with the issuance of the additional shares in the Earned Surplus, Capital Stock and Capital Surplus Accounts. The American Stock Exchange expects that the transaction will be accounted for in accordance with Accounting Research Bulletins of the American Institute of Accountants, i.e. if the distribution is less than 25%, the Corporation should account for the transaction by transferring from Earned Surplus an amount equal to the fair value of each of the additional shares to be issued, with Capital Stock Account increased by the par value of the shares, and Capital Surplus Account increased by the amount by which the fair value of the shares issued exceeds the par value. (State the basis of determining the fair value for the purpose of such transaction.) The fair value should closely approximate the current market price of the previously outstanding shares, adjusted to reflect the issuance of the shares to be distributed.

B. This application should be filed with the American Stock Exchange *in duplicate*. Copies thereof are not required to be filed with the Securities and Exchange Commission. The application should be filed with the American Stock Exchange prior to the payment date of the stock dividend or effective date of the split-up. If fractional amounts are to be adjusted by cash payment, it is advisable to delay the filing of the application until such date (after the record date) as the exact (net) number of additional shares to be issued has been determined and to file based upon that amount.

C. No registration application on Form 8-A, or otherwise, is required to be filed with the Securities and Exchange Commission under the amendments of its rules (particularly Rule X-12D1-1) effective January 28, 1954. However, it is necessary to file a Form 8-K report of the transaction (under Item 7 of such form), within ten days after close of the month in which the additional shares have been issued, if the increase in outstanding shares (or the aggregate amount of such increase and all such increases not previously reported) exceeds 5% of the previously outstanding shares of the same class of stock.

[EXHIBIT J]

AMERICAN STOCK EXCHANGE
86 TRINITY PLACE
NEW YORK 6, N. Y.
TELEPHONE REctor 2-0600

INSTRUCTIONS FOR APPLICATION TO LIST ADDITIONAL SHARES RESERVED FOR STOCK OPTIONS, STOCK PURCHASE PLANS, ETC., FOR OFFICERS OR OTHER KEY EMPLOYEES.

Requirement for Authorization By Stockholders

Approval of stockholders will be required as a prerequisite to approval of applications to list additional shares reserved for options granted or to be granted to officers, directors or key employees, regardless of whether or not such authorization is required by law or by the Corporation's charter. The Exchange requires that such stockholders' approval will be solicited pursuant to a proxy statement conforming to the proxy rules (Regulation X-14) of the Securities and Exchange Commission which will disclose all of the essential details of the options or of the plan pursuant to which the options will be granted. This policy does not preclude the adoption of a stock option plan, or the granting of options, subject to ratification by stockholders prior to the filing of an application for the listing of the shares reserved for such purpose. The Exchange may not require stockholders' authorization of options in cases (a) where options are issued to an individual, not previously employed by the Corporation, as an inducement essential to his entering into a contract of employment with the Corporation, and (b) where options are issued under a plan in which all, or substantially all, of the Corporation's employees participate, depending upon the maximum amount issuable to any one individual under the plan and the proportionate distribution contemplated by the plan.

Form and Content of Application

Two typewritten signed copies (or printer's proofs) of the application should be submitted.

(Sample applications furnished upon request)

The application shall recite, in substantially the order given below, the following:

1. TITLE PAGE, showing

(a) The name of the applicant, and when and where incorporated.

(b) The full title or designation of the security proposed for listing.

(c) Date of application and formal request for listing, specifying the amount, title and par value of the shares applied for, the purpose of issuance, and a statement that the shares, when issued for such purpose, will be fully paid and non-assessable, and whether personal liability attaches to ownership.

The number of shares applied for shall be limited to the specific amount authorized for issuance under the plan or individual options. The request for listing shall state the number of shares to be listed upon official notice of issuance for the specific purpose, i. e., "upon official notice of issuance pursuant to the exercise of options granted, or to be granted, under the Company's Incentive Stock Option Plan hereinafter described" (or whatever the case may be).

2(a). CAPITALIZATION. In tabulated form, the following: (1) designation or title of each class of stock, (2) par value, (3) number of shares (a) authorized by charter, (b) authorized for issuance (including unissued reserved shares), (c) outstanding, and (d) applied for.

2(b). As a footnote to "Capitalization", insert tabulation showing number of unissued shares of each class of stock reserved for issuance for any purpose, and purpose for which reserved. If no unissued shares reserved for issuance for any purpose, except the shares applied for, so state.

3. AUTHORITY FOR AND PURPOSE OF ISSUANCE. Under this caption recite the following:

(a) Dates on which the board of directors and stockholders authorized the stock option plan, the stock purchase plan, or (in absence of a general plan) the granting of the options for the purchase of the shares applied for.

(b) *Incorporation of Proxy Statement by reference:*

The applicant may at this point incorporate by reference the Proxy Statement describing the Plan (see above requirement for proxy solicitation) provided that the applicant has 500 copies of the Proxy Statement available for attachment to the 500 copies of the listing application which will be printed for distribution to the mailing list of the American Stock Exchange and others. At the option of the applicant, and as an alternative to the incorporation of the Proxy Statement by reference, the applicant may incorporate by reference a copy of the formal plan provided it contains all of the essential details referred to below. If 500 copies of the formal plan are available it may be attached to the listing application or, if not available, it may be printed as an exhibit at the end of the application.

Continue recital by stating whether any options have been granted since the date of the Proxy Statement and, if so, furnish the details thereof as called for by Item (c) (8) below.

If Proxy Statement or Plan is not incorporated by reference (see above) recite information specified below.

(c) In the case of *general formalized stock option plan*, recite all pertinent provisions of the plan, including the following:

(1) Purpose of, and consideration for, granting of options.

(2) Number or estimated number of optionees; specify number which are officers and/or directors.

(3) Administration of plan, whether by Board of Directors, committee, or otherwise.

(4) Basis or method of determining eligibility of participants.

(5) Option price(s). If established by formula (percentage of market price, etc.) state same.

(6) Duration of options and method of exercise, whether in whole or only in part from time to time, etc. If in part, state conditions.

(7) Terms and conditions of options with respect to transferability, termination of employment of optionees, adjustment in event of stock dividend, recapitalization, merger, etc.

(8) If no options have as yet been granted, so state. If options have been granted, furnish details as to number of shares, number of optionees, option prices and market value of the stock on the dates options were granted, unless such details are included in a proxy statement to be attached to the final printed listing application. If additional options have been granted since the date of the proxy statement, so state and furnish the above details with respect thereto.

(d) In the case of a *general formalized stock purchase plan*, furnish such of the above details as are applicable, subject to such variations as may be necessary to cover the particular provisions of the plan, including basis of determining the limitations upon the amount of stock purchasable under the plan, the purchase price and its relationship to market value, partial payment of subscriptions, etc.

(e) In the case of *specific options* (not part of a general plan) granted to a limited number of specified officers, directors or key employees as part of employment contracts, or otherwise, furnish

(1) The dates on which the options were granted.

(2) The total number of shares called for by such options.

(3) The exercise prices.

(4) The market value of the stock on the granting dates.

(5) The expiration dates of the options.

(6) The consideration for the granting of the options.

(7) Any other material conditions to which the options are subject.

(8) In tabulation form, furnish as to (a) each officer or director, and (b) each person who received 5% or more of such options, the name and title of the optionee, and the information called for by subdivisions (1), (2), (3), (4) and (5) of the preceding paragraph, as follows:

Names and titles of optionees	Number of shares optioned	Date of option	Exercise price of option	Market price of stock on date option granted	Expiration date of option

4. OPINION OF COUNSEL. State the name and address of counsel rendering the opinion filed in support of the application. If such counsel, or any partner of such counsel (or, if a firm, any member thereof) is an officer, director or stockholder of the applicant, this fact must be stated.

5. REGISTRATION UNDER SECURITIES ACT OF 1933. State whether shares applied for are registered under Securities Act of 1933. If not so registered, a statement must be made that legal opinion has been received that registration is not required, with a brief statement (cite applicable section of the Act) of the basis of exemption from such registration. If an exemption from registration is claimed under the second clause of Section 4(1) of the Act, state whether or not the shares are to be taken for investment by the purchasers.

6. SIGNATURE. Signature of officer of applicant authorized to sign application, as follows:

"This application has been executed by me pursuant to due authorization by the Board of Directors of the Corporation.

_____
(Name of corporation)

By _____"
(Title)

EXHIBITS

The following papers shall accompany the listing application:

A. *Copy of Plan or Agreement.* One copy of the stock option plan or stock purchase plan, if not attached to or quoted in full in the listing application. In the case of individual options (not

the subject of a general formalized plan), one copy of each option agreement or if more than one option has been granted, and all are identical, a copy of such agreement with a statement that all of the other options are identical.

B. *Opinion of Counsel* (one copy) of the issuer that the additional shares (specify amount) issuable for the purpose described in the listing application (specify purpose) have been duly and validly authorized for issuance and, when issued, will be fully paid and non-assessable, with no personal liability attaching to the ownership thereof. If such shares have not been and will not be registered under the Securities Act of 1933, the opinion of counsel shall also state why in his opinion registration is not required, citing the applicable section of the Act and/or the rule of the Securities and Exchange Commission under which exemption from registration is claimed, and the facts relied upon to make such exemption available. If an exemption from registration is claimed under the second clause of Section 4(1) of that Act, state whether or not the shares are to be taken for investment by the purchasers.

C. *Resolution re Listing.* Certified copy of resolution of the board of directors authorizing listing. A suggested wording is as follows:

"RESOLVED: that application be made to the American Stock Exchange for the listing of . . . (amount and designation of security) . . . of this Corporation, and that . . . (name(s) of officer(s) . . . be authorized by the Corporation to sign said application, to make such changes therein, or in any documents or agreements relative thereto, as may be necessary to conform with the requirements for listing."

D. *Listing Form L (Listing Agreements).* A copy of this form will be required to be executed and filed only if there has been a change in the standard form of agreements since the date of the issuer's previous listing application.

E. *Listing Fee.* The listing fee is computed at the rate of 1¢ for each additional share applied for. The maximum fee is $2,500 (i. e. if the additional amount applied for exceeds 250,000 shares, the fee is $2,500 regardless of the amount of shares). The minimum fee is $100 (i. e. if the additional amount applied for is below 10,000 shares, the fee is $100 regardless of the amount of shares below 10,000). The check in payment of the listing fee shall be drawn to the order of "American Stock Exchange".

Printing of Application:

500 copies of the listing application (either with or without proxy statement or copy of plan attached as the case may be) will be printed for distribution to members of the American Stock Exchange and others, plus such additional quantity as the applicant corporation will require for its own use. Applicant corporations are required to pay the cost of printing the copies for this purpose, being billed directly by the printer. In the letter of transmittal of the application please specify (1) whether or not the applicant has any preference as to the New York printer who will print its application, and if so, specify the name of such printer, and (2) the number of copies of the application which the corporation requires for its own files. If no preference is indicated the American Stock Exchange will arrange to have the application printed by its own printer, who will bill the applicant corporation direct.

Mr. ETHERINGTON. We would also like to submit a detailed statement specifying our reasons for supporting the legislation you are now considering.

Mr. STAGGERS. Very well.

(The document referred to follows:)

SUPPLEMENTAL STATEMENT SUBMITTED ON BEHALF OF THE AMERICAN STOCK EXCHANGE IN SUPPORT OF H.R. 6789 AND H.R. 6793

INTRODUCTION

Experience and study have shown the need for amendments of the Securities Exchange Act of 1934 and Securities Act of 1933 to help achieve three objectives:

(1) Improved investor protection by extension of the reporting requirements, proxy rules and "insider trading" provisions to certain companies whose issues are publicly held but unlisted;

(2) More effective self-regulation within the securities industry through improved standards of entrance into the securities business and better defined disciplinary controls over brokers, dealers, and their employees; and

(3) More adequate dissemination of information about companies by lengthening the period for delivery of a prospectus in an initial registered offering.

The American Stock Exchange supports H.R. 6789 and H.R. 6793 (collectively, the "bill") as a sound legislative basis for meeting these objectives.

IMPROVING INVESTOR PROTECTION

A major recommendation in chapter IX of the Special Study was the extension of the registration, reporting, proxy solicitation, and insider trading provisions of the Securities Exchange Act of 1934 to publicly held nonlisted companies. The SEC has embodied this recommendation in the bill.

Experience has confirmed the effectiveness of the federal securities laws, but has also revealed inherent deficiencies resulting from illogical application of the disclosure requirements. Although companies whose issues are listed on national securities exchanges are required to make timely and adequate disclosure to investors, many publicly held companies whose securities are traded over the counter are not subject to the same obligations. This uneven application of the Federal securities laws has traditionally been a source of great concern to Congress, to the investing public, and to the securities industry.

Registration by issuers

Section 3(c) would add a new subsection (g) to section 12 of the Exchange Act to require all issuers having total assets in excess of $1 million and engaged in interstate commerce to register with the Securities and Exchange Commission any class of equity securities held of record by 750 or more persons. The stockholder criterion would be reduced to 500 by the SEC 2 years after the effective date of the legislation, or by a later date if the SEC deemed a delay appropriate and advisable. The Commission would also be authorized to terminate the registration of any class of security upon a showing that the number of holders of record of that class has been reduced to less than 300 persons.

The provisions of this new subsection would not apply to classes of securities and issuers specified in paragraph (2) of the new subsection (g), including, but not limited to, securities of foreign issuers. With respect to foreign issuers, it should be noted that the Commission would be empowered to discontinue the exemption for any particular security if it finds that a substantial public market for that security exists in the United States and that the continuation of the exemption is not in the public interest or consistent with the protection of investors.

Section 3(d) would further amend section 12 of the Exchange Act by the addition of a new subsection (h) empowering the Commission to exempt, in whole or in part, any issuer, class of issuers, or affected person or persons from the provisions of the new section 12(g) and from the provisions of section 13, 14, or 16 of the Exchange Act if it finds that such action is not inconsistent with the public interest or the protection of investors.

Section 3(e) would also amend section 12 of the Exchange Act by including a provision that the powers, functions, and duties of the Commission with respect to securities issued by banks shall be delegated to any appropriate Federal banking agency requesting them.

The combined effect of these proposals would be in the public interest. Practical considerations necessarily limit the companies Congress should subject to the disclosure requirements to those of substantial size with a wide public distribution of their securities. The proposal in this bill presents a workable and reasonable test as to size and stock distribution.

Periodic reporting

Section 4 would amend section 13(a) which relates to the filing of annual and current reports and certain documents to make the provisions applicable not only to listed companies, but also to any company which is or becomes subject to the new section 12(g). This amendment satisfies the need for continuing disclosure compatible with the standards established by the SEC through years of experience and development.

Proxy solicitation

There is, at present, no statutory requirement that the management of any company solicit proxies. The existing proxy rules apply only if and when a proxy solicitation is made. Section 5 of the bill would amend section 14 of the Exchange Act, which now deals with proxy solicitation by companies listed on national securities exchanges, in three respects:

(1) It would extend the existing proxy rules and regulations to all companies that would be required to register under the new section 12(g);

(2) It would amend the existing proxy rules by requiring that all these companies either solicit proxies or transmit to their stockholders information substantially equivalent to the information which would have to be furnished if a proxy solicitation were made; and

(3) It would make it unlawful for brokers and dealers holding securities for customers to refrain from giving proxies in contravention of such rules and regulations as the Commission prescribed.

The value of proxy solicitation as a means for insuring a measure of corporate democracy is clear. The proposed amendments to existing proxy rules are consistent both with the policy of disclosing information which will make the stockholder's right to vote more meaningful and effective, and with steps taken by the stock exchanges with respect to listed companies.

Section 12 of the bill provides that the foregoing amendments to section 14 of the Exchange Act would take effect immediately upon enactment of the proposed legislation. This could create undue hardship on those listed companies that do not solicit proxies, but have scheduled stockholders' meetings within a short period of time following the enactment of the legislation. Immediate effectiveness of the amendments to section 14 of the Exchange Act would require those companies to prepare and file with the Commission and their stockholders information substantially similar to that which would have to be filed if a proxy solicitation were made. To prevent such a hardship, the exchange suggests that Congress defer the effective date of the amendments to section 14 for a reasonable period following the enactment of the bill. The Senate bill as passed incorporates this suggestion, and the exchange respectfully urges the House to concur in this technical amendment.

"Insider trading" restrictions

Section 8 would extend the "insider trading" provisions of section 16 of the Exchange Act to securities of companies that become subject to the registration requirements of section 12. "Insiders" are the officers and directors of the company as well as any beneficial owners of more than 10 percent of any equity security of the company. These provisions require that insiders report their holdings and transactions in equity securities, and they prohibit insiders from making short sales. They also allow a company to recapture short-swing profits from insiders.

The bill exempts from the profit recapture and short sale prohibition provisions transactions by a broker or dealer establishing or maintaining a primary or secondary market. A broker or dealer, therefore, could make a market for a company's stock while represented on its board of directors and not have to turn back to the company short-swing trading profits. This is a valid and important exemption.

The value and effectiveness of section 16 in preventing a breach of the fiduciary duty owed by directors, officers, and large shareholders to their corporations is clear. But the law results in one standard for one marketplace and one for another. This protection should not be conditioned upon the choice of a marketplace. The proposed amendment would correct this anomaly and equalize the protections against a breach of the fiduciary obligations of all insiders.

Disclosure of material contracts

Section 12(b) of the Exchange Act sets forth the information and documents a company must file when it applies for registration in conjunction with an application to list its securities on a national securities exchange. It would also govern the initial filing procedure for companies that would become subject to the requirements of the new section 12(g).

The existing section 12(b) does not require companies to file material contracts as part of their application under the Exchange Act, although the Securities Act of 1933 does require the filing of material contracts at the time the issuer makes a public offering of its securities. Section 3(a) of the bill would amend section 12(b) to place the provisions of the two acts on a parity. It would require the company to include, as an exhibit to its filing under the Exchange Act, all material contracts not made in the ordinary course of business which are to be executed in whole or in part after the filing of the application or which were made within 2 years before such filing.

Under the bill there would be practical problems in the initial compliance with this new requirement. Accordingly, the exchange suggests that the effective date of this amendment be deferred for a reasonable period following enactment of the bill to give listed companies already subject to the requirements of section 12 time to determine which contracts must be filed. The Senate version of the bill has adopted this suggested revision. The exchange respectfully urges the House to join the Senate in approving this technical amendment.

Unlisted trading privileges

Section 3(b) would delete clause (3) of section 12(f) of the Exchange Act under which the Commission may authorize an exchange to extend unlisted trading privileges to a security if certain statutory conditions are met.

Prior to the enactment of the securities laws, the privileges of the exchange marketplace were made available to many securities that were not fully listed. Markets were maintained because there was sufficient public interest in a security even though management had not sought listing. Since there was no listing agreement, there was no commitment to meet disclosure or other requirements.

In 1921, 80 percent of the issues traded on the American Stock Exchange were in the unlisted category. By 1950 the balance was about half and half. Today, more than 80 percent are fully listed, subject to the disclosure and related requirements of the SEC and of the exchange.

The position of the exchange is that it cannot (in the absence of legislation) compel disclosure by forcing a company from its marketplace to the over-the-counter market. Exchange policy is to encourage all qualified companies to see the advantages of meeting disclosure requirements and to consider listing. Whether or not a company meets disclosure requirements, transactions and quotations in its securities are exposed to public view when its securities are traded in a centralized market. In pursuing the policy of persuasion, the exchange has in mind these and related advantages to owners of securities admitted to dealings. The exchange would not be doing a service to the public if it were to sever connections with these companies abruptly.

The elimination of clause (3) would mean the Commission could not authorize the extension of unlisted trading privileges in the future. On the surface, it would seem that the exchange might take the position that retention of clause (3) of section 12(f) would be in its interest. This is a situation, however, in which the exchange depends on the effectiveness of sound policy based on broader considerations. If the bill is enacted, shareowners of the larger publicly held companies will be kept informed concerning corporate actions or developments. They will be in a position to question corporate policy on an informed basis. If the situation is such that it would be in the best interest of a company and its shareowners to list on an exchange, there would be less chance that those advantages would be ignored by management on a permanent basis.

For these reasons, the exchange does not oppose the elimination of clause (3) of section 12(f) as proposed in section 3(h) of the bill.

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Undertakings under the 1933 act

Section 15(d) of the Exchange Act requires a company filing a registration statement for a public offering of new securities under the Securities Act of 1933 to include an undertaking that it will file periodic reports keeping certain of the original information up to date. This obligation arises only when the aggregate value of its outstanding securities at the completion of the offering exceeds $2 million. Section 6(d) of the bill would amend section 15(d) to provide that any company which makes an offering under a 1933 act registration statement would be obligated to file these informational reports so long as the company has at least 300 security holders of record. The proposed amendment would assure continuous disclosure by many companies that now comply with disclosure provisions only at the time they make the public offering.

Special considerations regarding banks and insurance companies

In connection with prior proposals to extend the reporting, proxy, and insider trading provisions of the Exchange Act to over-the-counter securities, a recurrent question has been whether banks and insurance companies should be included. It has been said that both types of business are already adequately regulated.

State regulation of insurance companies is designed for the protection of policyholders. In the case of banks, the primary purpose is to protect depositors. The question, therefore, is whether new steps are necessary and appropriate for the protection of shareowners. Disclosure to investors obviously does not become less important because other authorities, for other good reasons, have other requirements to protect other people. The question must be weighed in terms of the national commitment favoring adequate and timely disclosure to shareowners, bearing in mind the purposes and aims of the State requirements.

In testimony before the Securities Subcommittee of the Senate Committee on Banking and Currency the American Bankers Association endorsed the principle of disclosure by banks, although it suggested that these provisions be administered by the appropriate Federal banking regulatory authorities rather than by the SEC.

The Comptroller of the Currency has now prescribed for national banks new regulations dealing with financial reports to stockholders and with certain types of proxy solicitation. These new regulations reflect a conclusion that confidential bank examinations to protect depositors are not an acceptable substitute for timely and adequate disclosure to stockholders.

Chairman William McChesney Martin of the Federal Reserve Board, during the Securities Subcommittee hearing, stated:

"* * * most of the information about a bank that is developed by the supervisory authorities must necessarily be treated by them as confidential, and the data now available to a bank's shareholders do not appear to provide all that they would need in order to make sound investment decisions."

Chairman Vinton C. Johnson of Century Shares Trust, a large mutual fund which invests in bank and insurance stocks, has noted that it takes a great deal of time, effort, and specialized knowledge to judge investments of this type, primarily because there is a definite "shortage" of readily available information. He has pointed out that there is no simple way for the ordinary investor to analyze these stocks on the basis of the specialized and technical information that is available. (Doyle, "Funds and Trusts," New York World Telegram & Sun, June 11, 1963, p. 43, cols. 1 and 2.)

These observations provide a sound basis for concluding that the SEC's proposal is acceptable to those in the best position to judge its purpose and its importance.

At the request of some of the banking regulatory agencies, the Senate version of the bill has incorporated an amendment to the original SEC proposal making it mandatory for the appropriate banking authorities to administer the bill. While it can be argued that greater efficiency and uniformity would result if the SEC administered the provisions, the exchange believes that the amendment has merit, since it vests jurisdiction over all banks in those agencies most familiar with the problems and procedures of the banks.

The exchange supports the Senate version of the bill and urges the House to consider it favorably.

Insurance companies, accepting the monumental assignment of investing billions of dollars annually, depend upon adequate and accurate corporate financial information. They act competently and confidently because of the disclosure re-

quirements imposed on other businesses. In this light, it is to be hoped that insurance company representatives will favor disclosure to shareowners by their own companies as provided in this bill.

Scope of the bill and administrative problems

The bill would not affect all of the estimated 11,000 companies whose securities are traded over the counter. The stockholder and asset tests are set at high enough levels to postpone the application of the registration, reporting, proxy and insider trading requirements during the early growth period of small businesses. Moreover, under section 12(b), the SEC could grant exemptions, classify issuers, and prescribe requirements appropriate for each class. Thus additional companies falling within the dual statutory standards could be exempted in whole or in part from section 12(g) and its related counterparts. For example, the SEC has stated that if there were any company with no business activity or very limited trading interest, it could be exempted from all but minimal reporting requirements.

At the 500-stockholder level, an estimated 2,200 companies with substantial assets would be prodded into a more responsive attitude toward their owners, and another 1,700 companies that are now required to report regularly (by virtue of sec. 15(d) of the Exchange Act) would be subject to the additional requirements relating to proxy solicitation and insider trading.

Aside from questions raised on behalf of banks and insurance companies, the few reservations concerning these proposals seem to be centered on the added time and cost involved for companies. This factor should not be given more weight than it deserves. A sampling of relatively small companies listed on the American Stock Exchange, supplemented by discussions with representatives of several major New York law firms and a major accounting firm, indicates that compliance with the specific requirements of sections 13, 14, and 16 would not be overly great in terms of time or cost.

The section 13 reports, commonly known as the 8–K (current report), 9–K (semiannual report), and 10–K (annual report) are not unduly costly or difficult for companies.

The 8–K is filed within 10 days after the close of any month during which specified corporate events of a significant nature occur. In a survey of law firms in the New York City area, the exchange found that the average cost of preparing an 8–K can vary from $50 for reporting routine matters such as election of a new board of directors to $400 for reporting more unusual and complex matters such as acquisitions. A sampling of companies listed on the exchange indicates that most of them file not more than two 8–K's in a year and that the average is 1.7 filings per company. Since certain companies, due to special circumstances may file as many as seven, eight, or nine forms per year, the overall average of 1.7 per year is perhaps misleading. In general, it appears that a company would have additional costs of no more than $200 or $300 per year in connection with filing form 8–K's, except under unusual circumstances.

Form 9–K, filed semiannually, contains midyear profit and loss and earned surplus information. This form is usually completed by the company without the aid of lawyers or outside auditors. The cost and administrative burdens are minimal.

Annual reports, designated as 10–K's, summarize material events of the preceding year and must be coupled with certified financial statements. Peat, Marwick, Mitchell & Co., an accounting firm well experienced in these matters, states that compliance for a company that has met the registration requirements of section 12 as it would be amended and which receives an unqualified report on examination of its financial statement, "* * * would not involve a material increase in the annual auditing fee which would otherwise be incurred. Compliance involves the expansion of certain financial statement captions, additional footnote disclosure, and the submission of additional schedules, data for all of which could be updated periodically by company personnel. These data, in our opinion, could be covered by the accountants' report in the absence of unusual circumstances without involving a substantial increase in time on which the audit fee is based."

The exchange also contacted certain law firms to determine cost incurred in meeting the section 14 proxy requirements. When a proxy statement covers the election of directors and similar routine matters, the legal charges of these firms are generally in the neighborhood of $500 and seldom more than $1,500. Reporting of major developments such as mergers, recapitalizations or adoption of stock option plans is more complicated, but even in these cases the cost of

preparing the proxy statement would represent only a fraction of the cost of preparing the legal papers necessary to accomplish the merger or recapitalization or to set up an option plan.

The cost of printing a proxy statement is determined by its length and the number of shareholders involved. The average statement runs about six pages. If the company had 1,000 shareholders, it would cost approximately $300. Mailing costs would be $200 to $300. Thus, the total expense for companies complying with the section 14 proxy requirements might reach $2,000, but would be substantially less in routine situations. These costs approach the $2,000 level only when the matters being reported are of major importance and require detailed explanation.

A consolidation of these figures indicates that the total cost of annual compliance with all of the requirements apparently would be in the area of $1,500 to $3,000 for the smaller industrial companies covered by the bill except in most unusual circumstances. In addition, it is important to note that the items of corporate and financial information called for in the current SEC forms are merely descriptions of factual situations. If the event cannot be described simply and succinctly, it is not because the SEC requirements are unduly complicated or overly demanding, but because the transaction itself is complex. The additional cost, if any, of describing the transaction for the benefit of the owners of the company necessarily will be no more than a small percentage of the entire undertaking.

QUALIFICATION STANDARDS AND DISCIPLINARY POWERS

An underlying thesis of the SEC Specialty Study, and of this legislative program, is that self-regulation by the securities industry must be encouraged. This means that effective self-regulation must be made possible under current conditions.

The growth of the securities industry and the investing population has been well cataloged in the SEC Special Study. The dangers in admitting inexperienced people have been well emphasized. For example, during a recent 2-year period, 53 percent of the newest broker-dealer firms involved in NASD disciplinary proceedings were subjected to the most severe penalties of the association (suspension or expulsion, sometimes with a fine) while less than 2 percent of th oldest firms were subject to such penalties.

Sections 6 and 7 of the bill would strengthen the standards of entrance into the securities business and require that every broker-dealer (subject to exemptions by the SEC) be a member of at least one self-regulatory organization. The disciplinary authority of the Commission and of the NASD over brokers, dealers, and their employees would also be refined and clarified.

Although nearly all member organizations of the American Stock Exchange are members of the NASD, and many of them do a large over-the-counter business, the proposals concerning entrance requirements are not directly related to the administration of a stock exchange. Moreover, the exchange already has comprehensive entrance requirements and procedures of its own. Nonetheless, we see this approach—and assess it in light of our own experience—as a sound one which should help shield the industry, and thus the public, against the entrance of unqualified people.

The disciplinary controls of the SEC are of direct interest to all organizations within the securities industry. Those sought in this bill strike us as being reasonable because they would enable the SEC to direct is disciplinary action to the particular person or persons it finds in violation of any of the laws or rules it administers.

Broker-dealer registration

Section 6(a) of the bill would amend section 15(a) of the Exchange Act by requiring all over-the-counter brokers and dealers who deal in securities subject to the act and who use the mails or interstate commerce to become members of a self-regulatory national securities association, such as the NASD. This would be in addition to the present requirement that such brokers and dealers register with the SEC. This amendment would serve the policy of encouraging self-regulation in the securities industry.

The NASD is an organization established by authority of the Congress and works closely with the SEC. The great majority of brokers and dealers known to be trading in securities subject to the act are now members of the NASD. But some are not. The importance of membership in the NASD is emphasized by other related legislative proposals which would empower the NASD to raise

its standards. If membership in the NASD is not required, any additional authority vested in it will, to a substantial extent, be rendered meaningless.

Development of regulatory powers of the SEC

Section 6(b) would amend section 15(b) of the Exchange Act in several major respects.

The necessity for proving the use of the mails or other similar Federal instrumentalities in connection with violations by brokers or dealers of the various sections of the act would be eliminated. The Special Study concluded that this jurisdictional requirement has impeded prosecutions under the act in the past simply because the task of proving use of the mails was too laborious or impractical. It felts that the broker or dealer voluntarily subjects himself to Federal jurisdiction by registering with the Commission.

The bases for disqualification of brokers and dealers would be broadened. The statutory bars now contained in section 15(b) of the Exchange Act are limited. For example, disciplinary sanctions imposed by the national securities exchanges or the NASD, even though resulting from misconduct involving securities transactions, are not a basis for refusal of registration by the Commission. Conviction of certain crimes, such as embezzlement and fraud, unrelated to securities, are not disqualifications under the statute. Willful aiding and abetting does not prevent registration as a broker or dealer. These and other past activities of individuals may indicate as much potential danger to the investing public as the securities offenses now listed in section 15(b). Accordingly, the Commission has proposed that the present list of bases for disqualification be expanded. It should be noted that many of the new grounds for disqualification are already set forth in the Investment Advisor's Act and to this extent the amendments would make the two acts consistent.

Other new disqualifying grounds have been proposed to fit the needs disclosed by the Special Study. Included in this list is a disqualification based on an individual's negligent supervision of employees resulting in a violation of the Federal securities acts. Under this provision, however, no person would be deemed to have negligently supervised his employees if he had established reasonable procedures to prevent and detect unlawful practices and if he reasonably discharged the duties and obligations incumbent upon him by reason of such procedures.

A third amendment to section 15(b) of the Exchange Act would enable the Commission to proceed directly against individuals associated with brokers and dealers, as well as brokers and dealers themselves. The SEC now has no direct power over individuals except by proceeding against the entire firm with which the individuals are associated and by naming those individuals as a cause in the proceeding against the firm. The Special Study concluded that this "shotgun" approach is cumbersome and inadequate. Furthermore, the SEC has no direct power to suspend or bar persons from being associated with brokers and dealers. In recognition of these structural weaknesses in the existing laws, the proposed amendments would grant the SEC the power to proceed directly against individuals who are associated with broker-dealer firms. These amendments are consistent with the concept of self-regulation.

Suspension of trading in the over-the-counter market

Section 6(c) of the bill would amend section 15(c) of the Exchange Act by authorizing the Commission to suspend summarily over-the-counter trading in any security for a 10-day period when the public interest and the protection of investors so requires. This amendment would give the Commission the same powers with respect to securities traded over the counter that it now has over securities traded on an exchange under section 19(a)(4) of the act. Past experience under section 19(a)(4) indicates that the power to suspend trading is an effective restraint on violations of the Federal securities acts. The amendment would complement the expanded coverage of the proposed section 12(g). This amendment would be a logical extension of established policy.

Development of regulatory powers of the NASD

Section 7 of the bill would amend in several respects, section 15A of the Exchange Act dealing with registration of national securities associations. First, statutory responsibility would be given to the NASD for the establishment of appropriate standards relating to training and experience for members and, for the first time, employees. There would also be standards relating to the capital requirements of members. The exchange believes that the fiduciary nature of

the securities business makes it just as important to screen out undesirable persons prior to the time they enter the securities business as it is to supervise carefully their conduct once they are admitted to the business. The exchange believes these amendments are consistent with the policy of supervised self-regulation by the securities industry.

Several proposals would clarify and expand the jurisdictional authority of the NASD or other national securities associations over individuals who are not registered with them, but who are associated with their members.

Further proposals would amend the provisions dealing with Commission review of NASD disciplinary action. In particular, the amendments would shorten the time for appealing disciplinary actions from 60 to 30 days. In addition, an appeal from NASD disciplinary action would not automatically stay the judgment of the NASD if the Commission found that a stay would not be in the public interest.

The Commission believes that the protection of investors often requires immediate effective action to prevent further wrongdoings. It also believes that the present awkward appellate mechanism often prevents such immediate and effective action. The exchange feels there is merit in the proposal.

MODIFICATIONS OF PROSPECTUS DELIVERY REQUIREMENTS

In order to assure the adequate dissemination of information about companies which raise capital through a registered public offering, section 4(1) of the Securities Act of 1933 requires each broker and dealer effecting transactions in newly registered securities to deliver a prospectus to each purchaser within the 40-day period following commencement of the offering.

It is generally felt that the provision has helped to make the basic disclosure philosophy of the Securities Act of 1933 more effective. However, the climate of speculation which prevailed in the late 1950's and early 1960's gave rise to new problems, particularly the "hot issue" phenomenon, which emphasized certain inadequacies in the 40-day prospectus delivery requirement. The Special Study found that many factors such as irresponsible publicity, unreasonable delays in deliveries of securities and the occasional failure of brokers and dealers to deliver the prospectus during after-market trading, greatly inflamed this "hot issue" phenomenon. As a result the Special Study and the Commission have recommended that the 40-day period be extended to 90 days in cases involving a company's first registered offering of securities to the public. The Commission reasons that this longer period of time is a more realistic appraisal of the period during which the distribution process continues in the case of a new issue.

The Commission also has recognized that the present 40-day period may have little practical value in connection with offerings of additional securities of an outstanding class, especially if the issuer is making adequate disclosure with respect to the securities already outstanding. Accordingly, the Commission has recommended that it be granted the power to reduce the present 40-day period where appropriate, in the case of companies for which a reservoir of public information exists. This amendment is both practical and realistic.

CONCLUSION

The Bill represent a major step toward equal protection for all investors under the Federal securities laws. Prompt adoption of the Bill is urged in the public interest.

Mr. ETHERINGTON. In preparing our statements, we have tried not only to consider the particulars of the Special Study and the bill, but also to assess the broad significance of both. One striking fact is that 76 of the 176 formal recommendations in the Special Study relate directly or indirectly to self-regulation by the securities industry. Another 47 recommendations concern disclosure to the investing public. Thus, the Special Study has focused current attention on the twin themes of national policy developed by the Congress in the securities laws of 1933 and 1934.

The exchange has commented on 67 recommendations touching on its constitution and rules or falling within its area of responsibility. Some are specific proposals and others suggest the need for further

study. In our statement, we have expressed our reasons for supporting 34 and opposing 20 of these recommendations. As to the remaining 13 recommendations, we have expressed our point of view and mentioned the considerations we believe require further study before firm conclusions can be reached.

Taken as a whole, the unmistakable conclusions of the Special Study are (1) that the securities laws are soundly conceived, (2) that the balance of responsibility between the Government and the industry is essentially correct, and (3) that current regulatory practices should be refined and strengthened, but not disrupted or abandoned.

The exchange has designated in its statement 293 separate provisions of its constitution and rules—65 percent of the total—having a direct bearing on the protection of investors. It is doubtful that any other industry can point to such a comprehensive system for governing its own conduct in the interest of the people it serves. Moreover, the system is always under review and subject to change as new needs are identified.

During the past 23 months, the basic revision of our organizational structure has been accompanied by important changes in exchange rules and policies. As part of our program, we have established a new unit to review all rules and procedures in light of current conditions, taking into account the Special Study recommendations. This work is important, but it is axiomatic that the rule can do no more than outlaw the act. Rules in themselves do not govern and no system of rules can ever anticipate the full potential for abuse by the relatively few individuals whose personal codes of conduct are deficient.

As the system of securities industry regulation has developed, the emphasis has remained with the individual, where self-control starts. The system rests on, and finds its strength in, voluntary compliance by individuals. If it were otherwise, the cost of self-regulation might long since have become prohibitive. The moment there is need for enforcement by anyone—a firm, a stock exchange, the NASD, a State authority or the SEC—the system is subject to unnecessary strain. The costs can be controlled, and the confidence of the public retained, only so long as high standards of personal conduct obtain throughout the industry.

The starting point of systematic self-regulation is individual self-control. The prevailing attitude of those who are regulated establishes the conscience of the regulatory organization and the degree of success it can attain.

Each new rule proposal must be weighed against the possibility that it may unnecessarily stifle the individual's initiative for self-control or overly complicate the job of those who must monitor the system for self-regulation.

The commitment of all stock exchanges and the NASD to meet their responsibilities to the public is clear. The recommendations of the Special Study are being studied in terms of this commitment by people throughout the industry. More immediately, the industry has dramatized not only its commitment, but also its conviction, by uniting behind the SEC in support of the bill you are now considering.

This bill would close gaps in the regulatory structure revealed by the Special Study and by 30 years of experience since the securities laws were enacted. In the broadest sense, it represents a move toward three important goals:

First, an upgrading of the standards of entrance and responsibility for people and firms in the securities business;

Second, a refinement of the disciplinary controls of the SEC over brokers, dealers and their employees; and

Third, an extension of disclosure requirements as the key element of investor protection.

The central philosophy of the securities laws might be capsuled in three sentences: (1) A person who buys securities is entitled to the facts; (2) a person who owns securities is entitled to know when the facts change; and (3) broker dealers should be honest, competent and financially responsible people. The policy is to reach these goals by disclosing facts to investors and encouraging self-regulation within the industry.

Experience has confirmed the wisdom of these policies, but it has also revealed how unevenly they apply. Most publicly held companies have no obligation to disclose pertinent facts to their owners (except in the case of new issues) unless they list their securities on a stock exchange. Broker-dealers can skirt the industry's self-control mechanisms if they are not NASD or stock exchange members. The NASD itself lacks some of the authority it needs to preclude the admission of unqualified people. The disciplinary powers of the SEC often leave it with a choice of being overextreme or underextreme, because of the difficulty of focusing its action on an individual directly responsible for a violation.

We support the provisions of the bill relating to the NASD authority and refinement of the disciplinary controls of the SEC, but we recognize the fact that the NASD and the Commission are most competent to discuss their significance. For that reason, and because of our historical commitment to the policy favoring disclosure to share owners, my remaining remarks will be directed to the importance of sections 3, 4, and 5, and 8 of the bill.

In the 1930's, special types of securities—railroad and industrial bonds, government bonds, public utilities, investment trust shares, foreign securities, bank and insurance company stocks—were traded over the counter. Blocks of securities considered too large to be placed in the auction market without provoking distortions or wide fluctuations were also traded over the counter. Generally speaking, however, active industrial stocks were traded on the exchanges.

In 1963, the shares of many industrial corporations having substantial lists of stockholders are traded over the counter, beyond the purview of the regulatory standards applicable to securities listed on the exchanges. The SEC report estimates that the dollar volume of sales in the over-the-counter market has risen from $4.9 billion to $38.9 billion during the last 12 years.

From a functional or economic standpoint, it is impossible to rationalize the difference in disclosure requirements in the two markets. The tested policy of timely and adequate disclosure to investors, who deserve a fair opportunity to help protect themselves against unwise or unsuitable commitments of their funds, should apply regardless of the marketplace. It is time to place the requirements applying to large publicly held corporations on a parity regardless of the market in which their issues happen to be traded.

A proposal that a company having assets of $1 million and 500 coowners file periodic reports and furnish reasonably adequate information to its stockholders is hardly extreme. When a company has sought the public's money—and found 500 or more people to share in the risks or rewards of ownership—it is right to insist that it keep those people reasonably well informed of its business progress and financial position.

The corollary provisions of the bill are equally reasonable. Large companies with wide share distribution would have to solicit proxies or offer their owners information substantially equivalent to that required in a proxy statement. With certain exceptions, trading of the stock by officers or directors, or those who are beneficial owners of more than 10 percent of the stock, would have to be revealed, and short-swing profits might be recoverable on behalf of all share owners. These are the well-tested protections already in effect for similar companies whose stocks are listed.

The bill would not affect all of the estimated 11,000 companies traded over the counter. The asset and stockholder tests are set at high enough levels to postpone the application of disclosure requirements during the early growth period of small businesses. But an estimated 2,200 companies with substantial assets and wide share distribution would be prodded into a responsive attitude toward their owners, and another 1,500 that now report regularly would be subject to the insider trading and proxy requirements.

The few reservations concerning these proposals seem to be centered on the added time and cost involved for companies. Yet a sampling of relatively small companies listed on the American Stock Exchange, supplemented by discussions with representatives of a few New York law firms and a major accounting firm, indicates that neither the time nor the cost would be overly great.

The initial statement to be filed by a company would involve accumulating information covering a 3-year period. The task is less demanding than the filing of a company when it seeks public investment under the 1933 act. As a one-time project, and not a continuing obligation, it should not present a great burden to any company having adequate books and records.

After the initial filing, the process is one of supplemental disclosure through periodic and special reports filed with the SEC as well as through proxy statements mailed to the stockholders. Based on our survey of lawyers, accountants and printers, we conclude that the total cost of annual compliance with all of the requirements now applicable to listed companies apparently would be in the area of $1,500 to $3,000 for the smaller industrial companies covered by this bill except in most unusual circumstances.

The details leading to this conclusion are set forth in the statement we have filed. The critical point is that no company, having turned to the public market for funds, should object to the relatively minor cost of keeping its owners and the public advised of its progress or problems.

I might say in view of our survey, that we find it very difficult to believe the statement written in the letter that Chairman Harris read yesterday that insurance companies would have to put $1.50 override on a premium to comply with this provision. We can't imagine that the cost figures could possibly be that high for any company.

Questions have been raised by spokesmen for insurance companies. There is much to be said for suggestions that these companies are already regulated. Surely no business wants to be stifled in a maze of redtape or have an unnecessary obligation to respond to authorities whose purposes or requirements may sometimes overlap in substance or clash in procedure.

We do not want to hold ourselves out as experts on technical accounting matters or the existing regulation of insurance companies. But we do suggest that such consideration should be weighed in terms of the existing national commitment favoring adequate and timely disclosure to shareowners. The critical point is that regulation of insurance companies, and their reporting, is designed for the protection of policyholders. The question is whether new steps are appropriate for the protection of shareowners. Disclosure to investors obviously does not become less important because other authorities, for other good reasons, have other requirements to protect other people.

Insurance companies handle the monumental task of investing billions of dollars each year. In doing so, they have at hand, and depend upon, adequate and accurate corporate and financial information. They act competently and confidently because of the disclosure requirements imposed on other businesses. It is fair to suggest that those who depend on the policy requiring adequate disclosure by others should comply with that policy themselves.

Since the early 1930's, "self-regulation" and "full disclosure" have become touchstone phrases characterizing the coordinate efforts by the securities industry and the SEC to help protect investors. The primary role of the stock exchanges for regulating their own operations and the conduct to their members has been adopted in practice and confirmed by law. The coordinate responsibility of the NASD and the SEC regarding the over-the-counter market has been established through the Maloney Act. Disclosure policies have been tested by experience through a depression, a wartime economy and a postwar expansion in the share-owning population.

The novelty of the securities laws, forged in the face of dissent and even outcry from many quarters, has disappeared. It would be difficult in 1963 to locate any responsible spokesmen for the securities industry, or for a publicly held company, who doubts the wisdom of these tested national policies.

The SEC is suggesting, with the bill now before you, that it is time for the Congress to build on the legislative structure established 30 years ago, making the application of fundamental policies protecting investors more uniform. The legislation is needed to supply the framework within which other recommendations of the Special Study can be considered. But it is also needed to give added safeguards to a broader public—safeguards that cannot be provided by the SEC or the industry without this basic move by the Congress.

We support the SEC in its conclusion and in its recommendations. Thank you.

Mr. STAGGERS. I wish to thank you on behalf of the subcommittee for your very fine statement this morning on the bills which are before us and for the material you have submitted in response to the committee's request of October 16. I think this reply especially should be commended. You have done a most thorough and responsive job in

setting forth the title of every one of your rules and indicating each rule which is affected with the public interest and showing each rule which the Commission did not comment upon. And finally in setting forth as to each rule upon which the Special Study did comment the nature of those comments as well as the Commission's position and your own viewpoint thereon. This is a tremendous work of great value to us in the subcommittee in our consideration of the subject and I am sure will prove equally so to the Commission and to others as well as to yourself. In addition, I know I speak for the entire committee when I say you and your associates are to be commended for your unstinted efforts for these past 23 months which you spoke of in accomplishing a major reorganization of the American Stock Exchange, a reorganization which our hearings of over 2 years ago all too clearly showed long had been needed. In this connection I would like to include in the record at this point an article which appeared in yesterday's Wall Street Journal, which places your reorganization accomplishments much more adequately than your modesty permits you to do so. So we are going to put this into the record at this point.

(The article referred to follows:)

[From the Wall Street Journal, Nov. 20, 1963]

AMBITIOUS AMEX—AMERICAN EXCHANGE'S "REFORM" OFFICERS PRESS FOR MORE IMPROVEMENTS—THEY TIGHTEN REIGNS ON ASE'S SPECIALISTS, BEAT BIG BOARD TO COMPUTER QUOTE SYSTEM—LISTING STANDARDS TIGHTENED

(By Lee Silberman)

NEW YORK.—The American Stock Exchange, long overshadowed by the nearby New York Stock Exchange, is taking steps aimed at catching up with its illustrious neighbor.

It may seem puzzling that the Amex, as it is called, should even harbor such aspirations in view of the scathing criticism directed at it by the Securities and Exchange Commission only 2 years ago. The SEC charged the Nation's second largest exchange with general laxity in administration and found serious irregularities in markets of some of its listed stocks. The Amex, however, has been almost completely reorganized since then. And its new administrators, brought in to put into effect changes urged by reform-minded members, who were acting partly under the pressure of the SEC investigation, are now setting their sights on still further improvements.

"You might say we're like the Avis car rental people who admit they're second largest in the field, but invite patronage anyway because their ashtrays are cleaner," says Edwin "Ted" Etherington, the American Stock Exchange's lanky, forceful, 38-year-old president, and a former vice president of the New York Stock Exchange. "We could not be busier cleaning ours."

Mr. Etherington was busy furthering his campaign in both New York and Washington yesterday.

In New York, the Amex announced it was tightening a bit its listing standards for low-priced stocks and reported it had removed from dealings 63 stocks that had failed to meet higher listing requirements adopted earlier.

But the development that probably is more illustrative of the Amex's greater ambitions occurred in Washington, where a House Commerce subcommittee began hearings on the SEC's report of its recently completed special staff study of the securities markets. Representative Oren Harris, Democrat of Arkansas, chairman of the full committee, late last month asked the New York and American exchanges as well as several other securities organizations to submit point-by-point comments on the report's recommendations.

Comprehensive Amex analysis

From the Amex the House committee received an elaborate 80-page document containing a comprehensive analysis of each of the 70-odd proposals made by the SEC staff on the operation of securities exchanges. The Amex presentation included a formal expression of the exchange's position on each point. The

New York Stock Exchange, by contrast, turned in a much less voluminous commentary limited generally to views of its staff members; big board governors chose to put off taking an official stand on the SEC's points until after their exchange completes, probably in early 1964, an exhaustive study of the SEC staff report.

There's little doubt, to be sure, that lawmakers and the SEC will pay closer heed to the official sentiments finally expressed by the big board, if for no other reason than that the New York exchanges handles more than 86 percent of the total dollar value of shares traded yearly on the nation's 14 securities exchanges. Yet the comprehensive analysis by the American exchange (it accounts for about 6.5 percent of annual market value) is highly significant. Over the years the Amex has been content to let the big board assert industry leadership on common problems. But now Mr. Etherington has served notice that those days are over.

"The American exchange will cooperate with other stock exchanges and industry groups, but in the final analysis we must speak for ourselves," he declared in a recent speech. The ASE governing board, he said, "is an active thinking board which does not intend to abdicate any part of its responsibility," as its predecessors were accused of doing on many issues in the past.

But he added that "our interests and challenges most nearly coincide with those of the New York Stock Exchange * * * and we will continue to cooperate in all matters of mutual concern."

Improvement efforts

Since assuming the presidency of the American exchange in September 1962, Mr. Etherington has pressed on several fronts to improve the exchange. Carrying forward stiffer rules adopted by the exchange membership effective in April of that year, he has been pushing to remove questionable stock issues from listing and to replace them with issues meeting more exacting financial standards. He has sought to improve the exchange's machinery of maintaining fair and orderly markets and to keep investors informed of any unusual developments affecting listed companies.

Mr. Etherington also sought to broaden the exchange's membership with a view to obtaining more member firm outlets around the country. Since last spring the exchange has sold 91 seats, boosting the total of full memberships by 17 percent to 590(under a special program permitting firms that had been maintaining tenuous "associate" member ties with the exchange to buy full memberships at a bargain price.

In pursuing these aims, Mr. Etherington has substantially expanded the American exchange's staff—a move strongly recommended by the SEC. In just a bit over a year, the Amex has added some 50 new supervisory people alone, including William Moran, a former top official of the SEC's New York regional office, who now bosses the ASE's enforcement activities. The Amex also hired two former members of the SEC Special Study staff itself; one of them, Rolf Kaltenborn, is now a special assistant to Mr. Etherington in charge of a drive to attract "new listings of high quality."

These staff additions have boosted the Amex's total employment 10 percent to some 570 persons and the operating budget to $7.3 million this year from $6.6 million in 1962. The increases have provoked complaints by some of "empire building." Says a partner in one large securities firm: "If they get much more organization over there, the redtape will be strangulating."

The more widespread belief, however, is that Mr. Etherington and his assssociates have done "a remarkable job in repairing the exchange's internal integrity and outward image," as one prominent broker puts it. The feeling at the SEC in Washington is equally laudatory. Comments a top aid: "The people now running the show are imaginative and flexible—in other words, not bureaucratic."

At the New York Stock Exchange, whose staff is about 2½ times the size of the Amex's some officials are becoming considerably more respectful of their competitor. "They're young ambitious fellows over there, and we're not forgetting for a minute they're competing for new listings," declares a big board spokesman.

The American Exchange and the various regional exchanges around the country long have been regarded as "seasoning grounds" for listed stocks until the issuing companies grow big and prosperous enough to qualify for listing on the big board. American Exchange officials, however, hope to change this. "Our aim is to provide such a good marketplace right here that companies will think twice about leaving, even if they're able to do so," says Mr. Etherington.

Specialists and news

Two key requirements for a good market, in Mr. Etherington's opinion, are an able corps of specialists, exchange members assigned to maintain orderly markets in listed stocks, and the prompt dissemination of news about any special developments on the trading in a stock or within the companies whose shares are traded on the exchange.

Amex enforcement officials are keeping a close watch these days over specialists' transactions in order to help secure a high level of performance from these key operators. To judge its specialists, the exchange has devised a new system that is generally regarded as more rigid than the one in effect at the big board. It is no accident that Mr. Etherington and his associates should be so concerned with specialists, for it was in this area that the SEC was most critical of the Amex 2 years ago.

The SEC cited a number of Amex specialists whom it charged with having engaged in improper practices by taking advantage for personal benefit of the specialists' intimate knowledge of the market for a stock. When a new governing board took over at the Amex under a revised constitution in 1962, it immediately took disciplinary action against 21 members, most of them specialists; one had his membership suspended for 3 years. So far this year 17 members have been disciplined, including the remainder of those criticized by the SEC.

Along with this vigorous policing of specialists' activities, the exchange earlier this year launched a program of training members interested in becoming specialists. This program was begun after a survey called for by Edwin Posner, exchange chairman, showed the average age of the Amex's approximately 160 specialists to be edging past 55. So far 16 members have been accepted into the training program and 9 have been "graduated" into the specialist ranks.

Quotations by computer

Mr. Etherington expects the American Exchange to improve its services to investors significantly in 1964 when a computer system will take over the job of giving bid and asked quotations of listed stocks. At present, telephone operators give this information to callers after looking up the latest quotations. A member firm subscribing to the computer service will be able to get instantly, from an electronic voice mechanism attached to the computer, not only the latest quotation on a stock, but also that stock's opening price, its high and low, volume and net change for the day.

The New York Stock Exchange plans a similar automated service as part of a new computer program, but the big board, bogged down by uncertainty over how long it will remain in its present building, was slow in launching its program and doesn't expect to have the service ready for use until at least mid-1965.

In another operation common to the two exchanges, the Amex has gone the big board one better. The New York Exchange long has followed a policy of announcing publicly only the suspension or expulsion of members and remaining silent on disciplinary actions of lesser severity. This was among the practices that provoked the SEC to liken big board operations to "a private club." For years the Amex patterned its policy after the big board's. Recently, however, the Amex governing board decided to make all disciplinary actions public regardless of the penalty so long as the offense caused an investor to lose money or involved the financial impairment of a firm, among other criteria.

Will the Amex ever graduate from being a market for low-priced stocks? Mr. Etherington isn't sure it will—or should. As he sees it, the future of the exchange in part continues to be one of "providing a national audience of investors for the Nation's corporate youth—stocks of relatively new companies with sound growth potential."

Opinion is mixed in Wall Street on whether the American Exchange in recent weeks has been living up to its own preachments.

Trading stopped in Barnes

Early last month, the exchange stopped trading for 3 weeks in the common stock of Barnes Engineering Co. after published reports that Barnes had developed a cancer detection machine sent its price spiraling to over $44 a share from $17 in just a few days. The exchange halted trading until the company disclosed how many of the machines it had made, how many it had on order and estimated how much sales of the machines would affect earnings. On the resumption of trading, the stock dropped to $36 and currently is selling at about $34. Investors who bought near the high accuse the exchange of unnecessary interference with the market but Mr. Etherington insists the exchange acted

properly in the case because "unclear disclosure" of the company's activities had made it impossible for investors to reach sound decisions.

The exchange has been criticized more sharply for its handling of trading in the stock of Tastee Freez Industries, Inc.

The Chicago-based franchiser of soft ice cream drive-ins early in September petitioned a Federal district court for protection against creditors while it sought to reorganize under the bankruptcy law. The ASE first stopped trading on the news but allowed it to resume after the company had issued a clarifying statement on its plans. Shortly thereafter, however, a routine report of stock transactions by company officers, directors, and other insiders disclosed that a substantial amount of Tastee Freez shares, pledged by company insiders as loan collateral with banks, had been sold in August, helping drive down the price. Some brokers complain the exchange was not alert enough in failing to find out about the forced sales and to make the information public. Tastee Freez stock currently is suspended from all trading by SEC order.

Mr. ETHERINGTON. Mr. Chairman, may I interrupt to say that your very generous comments will be one of the important rewards not simply for me but for a very hard working staff and for our board of governors, and I will call the remarks to their attention as soon as I get back to work. We are very grateful.

Mr. STAGGERS. We thank you for the good work and we hope you keep it up.

Mr. ETHERINGTON. Thank you, sir.

Mr. STAGGERS. I would like to ask one question at this time before I pass on to the others. Do you know that there are some difficulties with the position you hold and these are apart from the duties of that position? By reason of the situation with which you were plunged into necessarily, you have attained an explicitness that put you in a spot where we look for comment from you on some of the philosophy and principles of self-regulation. As I understand it, the bill before us proposes to invoke a new disciplinary policy and that is that while hitherto an exchange firm was accountable for the actions of its members or employees and was so discipline, it now is proposed that the Commission can and should move directly against an employee. I can appreciate why some firms would wish not to be accountable for the actions of some of their employees. But I wish you would explain to me why your exchange with its high standards of conduct and responsibility wishes now to relieve its members firms for this accountability and liability for actions of its employees?

Mr. ETHERINGTON. Mr. Chairman, in your last phrase, there was a cough in the back room. Why our exchange with its high standards wishes, and then I could not hear the rest of it.

Mr. STAGGERS. To relieve all of your firms of the responsibility for their accountability for the actions of its employees.

Mr. ETHERINGTON. Mr. Chairman, years ago when the stock exchanges, including ours, first began to develop their intricate organizations a person who bought a seat on a stock exchange and became a member could qualify his organization for what we today call member firm or member corporation status. At that time, however, if there was a transgression within the organization by anyone the only person accountable to the stock exchange was the member himself. As a result, if someone over whom he might have had no control, perhaps in some other part of the country in a branch office, did something that was improper, the problem that the exchange faced was either to overlook it or to punish the member who had no possible

accountability for what happened. As a result of that, the exchanges have developed the concept of allied membership where every partner subscribes to the constitution and rules and is amenable to the jurisdiction of the exchange. The same is true through a different format of salesmen, registered representatives. So the exchanges have long since adopted the rifle approach as compared to the shotgun approach and can discipline, if necessary, the person responsible for an act rather than the person who might have been a member who might not have been responsible and rather than the whole firm.

The SEC, until this legislation was brought to your attention, has been in the predicament, and therefore our firms have been in the predicament, that we were in years ago. The SEC in general must go against the broker-dealer firm, seeking suspension or revocation, because somebody or some people in that firm perhaps in a different part of the country did something improper. The bill proposes that the SEC have the same rifle as opposed to the shotgun approach that we do and be able to go against the person who actually did the wrong thing. Our firm's responsibility is not relieved one iota. Our firms are still responsible for the acts of their partners and their employees. But just as an exchange can single out the man who did the thing, so also should the SEC be able to single out the man who did the thing and not penalize the whole firm through an action against it as an entity. So I would say in response to the end of your question, that it is not a relief of obligation, it is merely a pinpointing of obligation.

Mr. STAGGERS. In that philosophy, if the firm is found guilty or having knowledge of this, that does not relieve their responsibility one bit under this proposal.

Mr. ETHERINGTON. Yes, I think that is correct. As a matter of fact, part of the bill relates to those responsible for supervising the conduct of others and says that you ought to supervise and if you didn't set up reasonable procedures, then you are responsible for the act of the person you ought to have supervised.

Mr. STAGGERS. As well as perhaps the person who did it?

Mr. ETHERINGTON. Yes, sir.

Mr. STAGGERS. That is all for now. Mr. Van Deerlin.

Mr. VAN DEERLIN. I would echo, if I might, the general comments that the chairman has made. I was quite impressed by the strength and clarity of that statement of yours. It was extremely well worded.

Mr. ETHERINGTON. Thank you, sir.

Mr. VAN DEERLIN. What safeguards does your exchange have to make sure that members don't get overextended in customer commodity margin accounts?

Mr. ETHERINGTON. Mr. Chairman, we have net capital requirements applicable to those firms that are doing business with the public. I think it is fair to say that I have to take notice of the matter that provoked your question, and I do want to say on that that I have been in Washington the last 2 days and not in New York and am not thoroughly briefed. One of the things that I want to do is get myself more thoroughly briefed not only on the particular problem but on the specific question that you asked before I take a flyer at it.

I hope you will forgive me for receding on that and perhaps answering you in a letter at a later date.

Mr. VAN DEERLIN. I think perhaps the Chair might accept something for the record on this, together with any cases like it that might have occurred previously, and what might be done to prevent the repetition.

Mr. ETHERINGTON. I do want to say that the very first thing I said is the most material. I am able to say that we have capital requirements and inspection and examination programs. We are alert to the general financial condition of firms. Regardless of what problem may have caused a difficulty in their financial position, the essential ingredient is the capital requirement and we have it and we try to enforce it.

Mr. STAGGERS. Would you, in conjunction with that, after you have had time to get back to New York and make comment, supply that for the record?

Mr. ETHERINGTON. Yes, sir.

(The document referred to follows:)

AMERICAN STOCK EXCHANGE,
New York, N.Y., December 26, 1963.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance,
Interstate and Foreign Commerce Committee,
House of Representatives,
Washington, D.C.

DEAR MR. STAGGERS: During my appearance before your committee on November 21, 1963, Mr. Van Deerlin asked what safeguards the American Stock Exchange has to make sure that members do not get overextended in customers' commodity margin accounts. The committee granted me permission to reply by letter at a later date.

Members of the American Stock Exchange must adhere to net capital requirements prescribed in exchange rules. Rule 446 requires a member organization carrying accounts for public customers to maintain a minimum net capital of $50,0000. Rules 466 (for partnerships) and 467 (for corporations) provide that a member organization's aggregate indebtedness to all other persons must not exceed 2,000 percent of its net capital. These rules also prescribe the method for computing net capital and the various liabilities to be included in determining aggregate indebtedness. For example, in computing net capital a member organization must include as a debit item the amount of cash necessary to meet margin requirements in a customer's undermargined security or commodity account.

If an organization's net capital falls below the minimum requirement of the rule, this information must be reported to the exchange immediately. The exchange will then investigate the cause of the deficiency with a view to seeing that the firm initiates appropriate corrective action promptly. If it is determined that a willful violation of the exchange's net capital rules has occurred, the matter is referred to the advisory committee or the board of governors for appropriate action.

In addition to its capital rules, the exchange has a program of examinations of books and records of member organizations. While examinations do not constitute an audit, the exchange examiners check for customer accounts that may reflect unusual concentration in commodities, as well as in securities. When such situations are discovered, the member organization is immediately alerted to take precautionary measures to preclude any violation of the exchange's capital requirements.

Margin requirements for commodities are prescribed by the commodity exchanges in contrast to margin requirements for securities which are prescribed by Federal regulation and supplemented by the securities exchanges. Exchange member organizations are required as a matter of practice to obtain initial margin, and to maintain margin, to the extent required by the rules of the commodity exchanges.

As you may know, a special committee has been appointed by the New York Stock Exchange to explore possible problems connected with commodity accounts of customers of member organizations. The American Stock Exchange is planning to cooperate in the program and you may be sure we will give careful consideration to measures which may appear appropriate to safeguard against repetition of the recent unfortunate events.

May I thank you again for the courtesies extended me during the hearings.

Sincerely,

EDWIN D. ETHERINGTON.

Mr. STAGGERS. Mr. Glenn.

Mr. GLENN. Mr. Etherington, I want to congratulate you and your staff on the reorganization which you have done in the last 23 months, particularly for the reason that there are some of us on this committee that visited the exchange shortly before that time.

We spent a day on the floor and going through the various offices. While we were somewhat confused, as usual, with a lot of charts and graphs, we were quite pleased with what we saw from a layman's standpoint at least as to the action on the floor. So that when the report came out shortly thereafter we were quite shocked with the disclosures which were brought out and which caused the reorganization. So we have more or less been watching the American Exchange more so than the others to see what has been taking place in the meantime and we are very, very pleased with it.

Mr. ETHERINGTON. Thank you.

Mr. GLENN. While we were there on that particular trip, you were just, I believe, beginning a process of automation. Has that continued and to what degree have you effected automation?

Mr. ETHERINGTON. The program that was just beginning when you were there had to do with the automation of our telephone quotation system. As you know, a stock exchange really stands for two basic concepts. Full disclosure, which is mentioned in the bill before you, and full exposure of market data as close to the time that the market data is produced as possible.

This is through the ticker tape and otherwise. We have on the seventh floor of our building some 85 or 87 girls who answer telephones for brokers and give the quotations on stocks at the moment when the phone call is made. The automation program starting when you were there had to do with the creation of a computing system where market data would be fed into the computer and a piece of equipment which really amounts to a machine that will answer a telephone call. We did turn that program around in the course of our reorganization from a financial and operating standpoint, and we now have, instead of a piece of equipment that we will buy, a service arrangement with an outside company that has built this equipment to give up triplicate backup and three times the capacity. We are hopeful our volume will soar in the future.

We have just created, and are starting to test yesterday and today, a new ticker and quotation input station in the basement of the exchange through which market data will be fed into the computer. We hope to start early next year the actual automation whereby the broker can call up and a machine that will talk back to him will give him not only the quotation, the bid and the asked but also the last sale, the high, the low for the day, the net change from the previous day and the volume of that stock to that moment, for all of the stocks listed on our exchange at any given moment. The calls can be made simultane-

ously. That is the first and we think the critical step in the major automation program. We also hope to be able to use the same equipment to help us in market surveillance work that we now do through human beings.

Mr. GLENN. Of course, I know that the stock market business is highly competitive and I presume you at times get companies listed on your exchange that were or are on the New York Exchange and vice versa.

Mr. ETHERINGTON. I am afraid it is not vice versa. It is versa vice. The tendency is to go from us to New York and we hope to stop the tendency.

Mr. GLENN. Is this something recent or has this been going on before the reorganization? I was impressed by the statements that were given to us over 2 years ago that you were at that time successful in getting some of the corporations and businesses from the New York Stock Exchange. What is the situation today?

Mr. ETHERINGTON. Of course, I was not with you at that time.

Mr. GLENN. No, you were not.

Mr. ETHERINGTON. I am not responsible for what was said to you. Occasionally a company may fail to meet the continuing standards for listing on New York and then strengthen itself and get up to our original listing standards and we might list it. In general the historical purpose of the American Stock Exchange, in addition to providing a home for some blue chips and steady dividend payers, has been to make a home for what might be called the corporate youth of the Nation, the smaller growing company.

Our listing standards are, in general, lower than New York but high enough to assure that we will not take on a company not ready to be traded in a national auction market. When a company grows and gets bigger and has wider share distribution it may come to the point where it fits the New York Stock Exchange listing standards and historically many of the companies that get to that point then seek a listing on the New York.

It is that tendency that we would hope to stop by good performance.

Mr. GLENN. If we pass this bill and it becomes the law, what will be your position insofar as competition is concerned with the over-the-counter market?

Mr. ETHERINGTON. I would say that our position would not be materially changed from what it is today. We hope that every qualified company now traded over the counter, and there are many of them that are qualified for listing on our exchange, is actively considering the advisability of listing today. Conceivably the passage of this bill would accelerate the trend because some of the things that they would have to do to list would have to be done under Federal law if this bill were passed.

However, this is not a bill related to listing. It is related to disclosure and we have other requirements, both as to the size and share distribution of the company and as to what it must do once it is listed that are not covered in this bill. So what we can hope for would be an acceleration of a trend that we think exists. But it would not in itself provoke any single listing.

Mr. GLENN. Thank you very much. Thank you, Mr. Chairman.

Mr. STAGGERS. Mr. Harris.

Mr. HARRIS. Mr. Chairman, I am sorry I was not here for all of the presentation of Mr. Etherington. However, when I requested recently that you provide the committee with a statement you were very kind to comply. I want to thank you for it. We have had an opportunity, of course, to go over your rather comprehensive statement which you referred to and explained in more succinct terms in your statement. I merely want to say that I join the other members of the committee, in complimenting you, Mr. Etherington, for the splendid work that you have accomplished as president of the American Stock Exchange and the progress that you have achieved in the last relatively short time. We appreciate the contributions that you have made to the problem. I particularly want to compliment you also for the manner in which you have treated this subject in your comprehensive statement which you filed in response to my request.

In going through it, I observe the treatment that you have given to the study report and note particularly the comments that you make on certain of the rules which you thought would be appropriate for you to be commenting on. I know you have a tremendous responsibility. I know there were some problems with the American Stock Exchange. The way that you and those associated with you have taken over and realized fully that some adjustments were necessary the way you have attacked those problems and have strengthened, in my judgment, your position and your responsibility in administering the program of the American Stock Exchange is gratifying to me and that the industry has taken upon itself to really do something about it. I commented yesterday and have previously commented on the actions of the industry.

The industry has adopted the so-called self-regulation principle—the industry policing itself. Under our system I think it is a very fine thing that we have that approach. I for one believe that principle is responsible largely for the accomplishment of industry in this country in many fields where they have increased—not only maintained—but increased their lead and assumed the leadership role in so many of these problems that are considered by the other nations of the world.

Recently I attended the telecommunications conference in Geneva. You only have to go to one of these to see the questions raised by representatives of other nations, large and small, and when you have people that represent your country as the delegation from this country did, informing people of these nations what we had, what we have done and what we hope to do and what we expect to do, and then gain their confidence as they did in this case, it gives one a great deal of encouragement that this system of ours is the right system and it cannot only make us strong but stronger as we go along.

Certainly you are in a field that has a lot to do with the strength of the economy of this country and, therefore, add to the position of this country in the field of economics and how the rest of the world looks at us. What you have done in the last 2 or 3 years in this regard is heartening to me and I want to compliment you for it.

I don't believe, Mr. Chairman, in view of the questions that have been asked and the statements that have been given that I have any detailed questions which I would propound to Mr. Etherington at this time. I know you and other members of the committee have cov-

ered these matters generally fairly well at this time and probably will as you continue here. But I did want to make public acknowledgment of the cooperation which you and your organization have given to the committee in the development of the record in order that the facts of this industry may not only become known to us in the Congress but to the people throughout the United States.

Mr. ETHERINGTON. Thank you very much, Mr. Chairman.

Mr. STAGGERS. Mr. Curtin.

Mr. CURTIN. I have no questions, Mr. Chairman.

Mr. STAGGERS. Mr. Etherington, I think you were in the room this morning when I mentioned to Mr. Day that perhaps one of the reasons that the exchanges supported the Frear and Fulbright provisions of the bill, the provisions of reporting, proxies and insider trading, over the counter, was a desire to get additional listings. Do you care to comment on that?

Mr. ETHERINGTON. Yes, sir. I would like to say unequivocally—I would like to put on two hats for the moment—with my stock exchange hat on I would be far less than candid to tell you that this bill won't help us. I suspect that it would call attention to the advantages of listing and remove some impediments.

But I would like to put on my individual hat for the moment, and I am sure all of us here would agree with this, we think this is sound legislation in the public interest regardless of the jobs that we hold.

Mr. STAGGERS. Haven't the exchanges also taken the position always that the public could be assured of better protection when they bought listed stocks?

Mr. ETHERINGTON. I think the answer to that probably is "No." I think the exchanges have taken the position, and rightfully that the public is better able to protect itself in approaching the purchase or sale of a listed security because there is disclosure of information and exposure of market data. That is what this bill would help provoke on a wider scale.

Mr. STAGGERS. If the public is going to be equally protected, would it be just as well to have no listings?

Mr. ETHERINGTON. To have no listings?

Mr. STAGGERS. That is right.

Mr. ETHERINGTON. No, sir; because exposure of market informations ties itself back into the ticker tape. The facts on the market are exposed as trading occurs, bids and asks are available, they are made available to the broad investing public. The value of the central auction market is what I am talking about.

Mr. STAGGERS. Has there not been some consideration, though, given in the past to the question whether the tape or the ticker that you mentioned was not harmful and that we, like the British, should have none of it? Hadn't that been suggested?

Mr. ETHERINGTON. I am sure it has been suggested. I am positive I don't agree with it.

Mr. STAGGERS. I can understand why. Since the role of the specialists on your exchange has highlighted the need for, and sparked the Commission's study, I think it would be appropriate for you to comment somewhat more at length on what you have done to improve your rules in this area?

Mr. ETHERINGTON. Concerning specialists, sir?

Mr. STAGGERS. Yes.

Mr. ETHERINGTON. I would be glad to. I would like to say, first, or to repeat first the statement I made—the prepared statement that I read—that I am convinced it is not the rule that governs but rather the character and integrity of people who are subject to the rule and the procedures for those used by those whose job is to monitor the self-regulatory system. In part 2 of the statement we filed we have detailed for the committee our own market surveillance, enforcement, investigation, examination, and disciplinary procedures to make the rules work. That is the first major step that we have taken. In addition, at about the time I took office officially in September 1962, we commissioned an outside firm to make a study of the standards that could be used to test specialists' performance. Getting into this field I would like to emphasize that there is a great deal that is subjective in the Saperstein doctrine of the 1930's. In our rule 174, in the SEC and the stock exchange approaches to what is a good market. The question is, When should a specialist participate? When should he go against the trend in order to make fairer and more orderly markets? Nonetheless we are convinced that the theme of that part of the Special Study is essentially correct. All existing standards are not necessarily correct standards. We think we got to that idea and got moving on it before we read what the Special Study had to say because we had been studying it for 14 months. As a result we have started a few new tests helped to design—to tell us whether specialists are performing well in the public interest. We are now convinced there are other tests we can adopt. We are going to go very slow. We want to have meetings with specialists in order to broaden our own perspectives. These are professional problems. I, for example, have never been a specialist. I want to be sure I can draw on the best knowledge of people in the marketplace as well as the best knowledge of outsiders who may give us ideas.

In addition, and I think this is or was part of the thrust of your question, we think we are very alert on a moment-to-moment basis as to what is going on in the marketplace both through people on the floor charged with watching what is happening and through a market surveillance program outlined in our statement, in which we have set up norms for each stock. When there is volume or price action outside of the expected norm we find out why and we do it promptly.

Mr. STAGGERS. Then I gather from your answer that you are satisfied that there is a need for specialists?

Mr. ETHERINGTON. I am convinced that the specialists are the heart of the auction market and the auction market is a part of the heart of the economy. The answer to your question is "Yes."

Mr. STAGGERS. Also that you have started certain remedies and certain actions in governing the actions of specialists?

Mr. ETHERINGTON. Yes, sir; we have.

Mr. STAGGERS. Yesterday, Chairman Cary was asked whether manipulation in the markets today was as rampant as Mr. Cary had testified it was 24 months ago when we were considering House Joint Resolution 438 authorizing the study. I was amazed and startled—if I heard him correctly—by his answer which I believe was that manipulation was even more so today. Would you comment in the light of your experience upon the new rules of the American Stock Exchange?

Mr. ETHERINGTON. Yes, sir. May I first say I hope that the committee will consider contacting Mr. Cary, which I have not done, for clarification? I believe, as I heard him, what he meant to say—I was as startled as you were—I believe what he said specifically was that there had been more criminal referrals by the SEC and I believe he meant by that the SEC was doing a more alert job than they did before. He was not making a quantitative judgment as to the manipulative activities in the securities markets, merely a qualitative judgment of what job was being done currently by the SEC. I can't speak for him but I hope that question will be asked of him. As to our own marketplace——

Mr. HARRIS. Before you leave that, I asked the question of Mr. Cary yesterday and I don't think I misunderstood what he said.

Mr. ETHERINGTON. I am sure you didn't. I think maybe he didn't mean to say it.

Mr. HARRIS. Maybe not. But the record is still there. He was pretty positive about it. I was quite amazed, too. You are very generous in trying to interpret what he said. But I would like to get a more responsive answer to the chairman's question.

Mr. ETHERINGTON. Yes, I was going to go on to that. He asked me specifically about our marketplace, as I understand it.

Mr. HARRIS. All right.

Mr. ETHERINGTON. Is that right?

Mr. STAGGERS. Yes.

Mr. ETHERINGTON. I believe that anyone who sat before you and said unequivocally that nothing was going on that he didn't know about would be a foolish human being. But I am convinced that during my tenure of office—the last 14 months for which I am accountable—that the answer to your question is unequivocably "No," there is not as much—if there was manipulation before. Certainly manipulation is not anything like rampant in our marketplace.

Mr. STAGGERS. You say if there was manipulation before?

Mr. ETHERINGTON. Yes. I would rather not characterize what went on before I became responsible. But we are doing an intensive job of surveillance and enforcement and we have not found manipulation in the marketplace.

Mr. STAGGERS. I believe, in the light of the record, that anyone versed with the activity of the exchanges would probably say that there was some manipulation, not if there was. I can understand your reply.

Mr. ETHERINGTON. Thank you.

Mr. STAGGERS. Mr. Etherington, it is my impression that the Special Study Group devoted considerable attention to the role of the floor trader and makes certain recommendations respecting the continuance of floor traders. I think chapter 11 characterizes this trading as being a vestige of the former private club nature of stock exchanges and in general recommends that floor trading be prohibited. What is the exchange's position on floor trading, and what is the exchange proposing to do about it?

Mr. ETHERINGTON. Mr. Chairman, as I read the Special Study it conceded that floor trading added to the liquidity of the marketplace, a factor emphasized by Mr. Funston in his prepared statement for you yesterday, and then went on to say that it was a vestige of a

former private club atmosphere and recommended that floor trading be abolished. Mr. Cary, if I understood him correctly yesterday, said that the Commission was impressed by the brief made on this point by the Special Study and then went on to say that he had asked us to show cause why in effect floor trading ought to be continued. I would take issue with the statement that the Special Study was an adequate brief for a proposal that a form of trading on the floor be eliminated completely. For example, the Special Study recommendation was not based on a current study of floor trading on the American Stock Exchange. There is no claim that any such study was made. I also think that a move to eliminate or seriously curtail floor trading ought not to be based on a characterization of a former private club atmosphere at a stock exchange, whether or not one in fact did exist before I was heard of.

We have commissioned outsiders to do a study of the floor trading on a current basis to try to determine the extent of liquidity conceded to be supplied by the Special Study. We want to find out to what extent liquidity is aided. This is in answer to your question of what we are doing about it.

Mr. STAGGERS. You say you have a special study group?

Mr. ETHERINGTON. We have a group going to work on this to analyze our market and try to show how much liquidity is supplied by floor traders. We hope when we have that added ammunition, which will amount to a current study, then to give a specific reply to the SEC. Our stand is that any move to take away the right to do business in a certain way of an existing group of people, or any move which would undermine the liquidity of the marketplace, should be supported by very strong evidence of public need. We have not seen that evidence as yet.

Mr. STAGGERS. I am glad you added that last—"public need"—because most laws are made because of the need. I never knew of anyone who wanted a law passed to regulate himself. What is the Special Study Group comment concerning the composition of your board of governors? Would you care to comment on that?

Mr. ETHERINGTON. Yes, I think its general comment in chapter 12–C was to describe the changes in the makeup of our board so that it now represents all segments or other segments of the country in addition to New York through out-of-town governors and all segments of the business and limits representations of any particular segment of the business.

That general move was described and then characterized as a part of a broader phrase complimenting the exchange on its reorganization program. So I read the Special Study to commend our move to redesign the makeup of our board just as we redesigned the total structure of the exchange. I would gather from the Special Study that what we have done is completely sound in their view.

Mr. STAGGERS. Then you said it does represent all facets of your operation?

Mr. ETHERINGTON. Yes, sir.

Mr. STAGGERS. And does it include any public members?

Mr. ETHERINGTON. Yes, sir; three. In addition to the president.

Mr. STAGGERS. I just wondered, how independent of the New York Stock Exchange is your board?

Mr. ETHERINGTON. I think it is completely independent of any other organization including the New York Stock Exchange.

Mr. STAGGERS. In the course of our hearings on House Joint Resolution 438 questions were asked concerning the protection afforded investors by various rules of the exchange relating to positions in other firms which members of the exchange might hold subject to the approval of the exchange, such as officers and directors of nonmember corporations. At that time your exchange had to be informed, but, unlike the New York Stock Exchange, it did not have to approve any such situations where there might be a conflict of interest or a possibility of utilizing inside information for profit. Are your rules the same today?

Mr. ETHERINGTON. Mr. Chairman, I am not positive that I fully understand the question. Can I try to restate it and see if I have stated it correctly?

Mr. STAGGERS. Yes. I will give it to you again.

Mr. ETHERINGTON. Yes, sir; that would help.

Mr. STAGGERS. At that time your exchange had to be informed of this existing interlocking organizations of its members but unlike the New York Stock Exchange it did not have to approve any such situations where there might be a conflict of interest or a possibility of utilizing inside information for profit.

Mr. ETHERINGTON. I am going to ask you if I can reserve the right to review my answer after I have given it but I think I will be correct in my answer. The basic concept of the American Stock Exchange, by rule, is that a member or allied member must devote the major part of his business to the business of his firm; that he cannot take an operating position in another business venture, for example, president of a corporation; that he can't be associated in any way with a different financial or kindred business, and if he has such a position, for example, as a directorship outside of his member firm that must be approved in advance by the American Stock Exchange. The only part of your question that I am hesitant about is to say when that rule was changed.

I reviewed the rules very thoroughly when I took office. I am confident that I have stated the rule correctly. But I am not certain when it went on the books. May I have just a moment with my counsel? There is an important addition to that. Under our rule 96, we have gone further with one group, the specialist. We prohibit a specialist from being an officer of any corporation in whose stock he is registered as a specialist, nominating anyone to that board of directors, soliciting any proxies or entering into a proxy contest. Then without being able to cite the rule but from memory I can tell you that just recently, in the last 15 months, we passed a rule saying that a specialist could not take an order from an officer, director, or insider of a corporation in whose stock he specializes.

Mr. STAGGERS. Let me ask you just one more question. The Securities Exchange Act of 1934 is premised to a substantial degree upon the principle that both the exchange and over-the-counter rules should be substantially self-governing, but certain rules for the protection of the public in the conduct of their operations. I note that the staff study, chapter 12, concludes that regulation in the security field should continue to be based upon this principle of self-regulation wherever

and to the extent that regulatory need can be satisfactorily met through self-regulation.

The study goes on to state, however, that Government participation is necessary also to assure that action taken in the name of self-regulation fairly serves as a valid public purpose and is not for a purpose inimical to antitrust or other public policies. Conversely, the bona fide self-regulatory action is not inhibited because of a risk of liability in the absence of commission review. I wish you would comment on whether or not the statutes today are adequate with regard to carrying out this self-regulation for those purposes.

Mr. ETHERINGTON. Mr. Chairman, I do not know the answer to that question. I read the *Silver* case which involved litigation between the New York Stock Exchange and a party on the other side. We were not parties to it. I heard Mr. Cary yesterday characterize correspondence and conversations he has had with New York and I have heard about that but was not privy to it. I heard Mr. Funston's statement. I think this is a deeply complicated question of great concern to the Congress, to the SEC, and to us.

It is going to require very careful study. I think that study ought to be, as the SEC suggested in its letter to you, in coordination with the industry people involved. I can say that I would not advocate legislation at this time because such a study and such careful thought has not been given. But I do not want to be on record as saying that legislation at sometime might not be an appropriate move.

Mr. STAGGERS. Would you recommend that a study be made of this? I was going to mention the Silver case specifically. You would recommend in light of events that further study be taken on this?

Mr. ETHERINGTON. More than that, I can tell you that we are pondering the question ourselves very carefully and we are sure we will be discussing it within the industry and with the SEC.

Mr. STAGGERS. You probably remember Chairman Cary reserved his opinion in that category, that there might be additional legislation needed.

Mr. ETHERINGTON. Yes, sir, I heard that.

Mr. STAGGERS. I wanted to get your comment because I believe, too, as you, probably further study should be made on that.

Mr. Glenn.

Mr. GLENN. Mr. Etherington, perhaps I should have asked this question of Mr. Cary yesterday when he gave his criticism of floor trading and specialists. Can there be any substitute for floor trading and specialists in the stock markets?

Mr. ETHERINGTON. I think there can be no substitute for the specialists. The specialist is the unique—the specialist system—is the unique mechanism of our auction markets. I think I can just end that answer there. I don't see any substitute. As for floor trading, I don't know how you would replace the liquidity that would disappear when he disappeared, as a trader. I think my answer therefore would be no.

Mr. GLENN. Thank you very much. That is all, Mr. Chairman.

Mr. STAGGERS. Following that up, I think Mr. Funston agrees with you with your statement. I gathered that by mechanical means somewhere there could be gathered and disseminated and brought back and forth—the buying and selling. That in time might be a possibility?

Mr. ETHERINGTON. I just don't believe it, Mr. Chairman. Automation has its limits. I have yet to see a little black box that has the timing and money and the courage and the judgment to do the job that a human being can do in bringing the people together.

Mr. STAGGERS. You go around the corner and Macy's will sell you anything.

Mr. ETHERINGTON. I don't believe they will sell that.

Mr. STAGGERS. Again, on behalf of the subcommittee, I want to thank you for your response to our questions and your response to our letters of inquiry. I also wish to commend you.

Mr. ETHERINGTON. Thank you very much. Thank you for your generosity.

Mr. STAGGERS. Mr. Lemkau, we are glad to welcome you to the committee, together with your associates. I recognize among them one who has been before us in the past, ex-Commissioner Goodwin. I am also pleased to welcome the newly designated president of your association, Mr. Robert Haack of Milwaukee.

I note the presence of Mr. Avery Rockefeller, who has been head of the Commission's advisory committee on this legislation. Mr. Wallace Fulton and Mr. Marc White are old friends of the committee. They have assisted us greatly in the past with their ever helpful counsel and readiness to supply information.

If I have missed any of your associates, I wish you would state your name and position, and give their names and position capacities.

STATEMENT OF HUDSON B. LEMKAU, VICE CHAIRMAN OF THE BOARD OF GOVERNORS, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.; ACCOMPANIED BY MARC A. WHITE, GENERAL COUNSEL; A. JACKSON GOODWIN, JR., MEMBER, BOARD OF GOVERNORS AND CHAIRMAN, LEGISLATION COMMITTEE; ROBERT W. HAACK, CHAIRMAN, NATIONAL BUSINESS CONDUCT COMMITTEE AND CHAIRMAN-ELECT OF BOARD OF GOVERNORS FOR 1964; AVERY ROCKEFELLER, JR., CHAIRMAN, ADVISORY COMMITTEE TO BOARD OF GOVERNORS; WALLACE H. FULTON, EXECUTIVE DIRECTOR; AND JOHN HODGES, STAFF MEMBER, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Mr. LEMKAU. Mr. Chairman and members of the subcommittee, I am Hudson B. Lemkau, of New York City. I am a vice chairman of the board of governors of the National Association of Securities Dealers, Inc., and have been serving as acting chairman of the board since the illness early this year of our chairman, Merrill M. Cohen, of Minneapolis, Minn., who died in June.

You have identified the other gentlemen with me.

I might state that Mr. Goodwin is chairman of the association's legislation committee, that Mr. Haack is a member of the board of governors, chairman of the national business conduct committee of our association, chairman-elect of the board of governors for the year 1964, and as you stated, yesterday he was elected to the position of president of the association to take office upon Mr. Fulton's retirement on April 1, 1964, after Mr. Haack relinquishes his duties as chairman of the board on that date.

Avery Rockefeller, of New York City, is chairman of our advisory committee, and he is a past chairman of the board of governors.

Mr. Fulton, as you know, is our executive director, and Marc White our general counsel.

Our association was, as the committee knows, established under the authority of the Maloney Act of 1938. It operates through local committees in 13 geographic districts, upon which serve 125 individuals actively engaged in the securities business, and through the board of governors, consisting of 21 such individuals.

These groups are supported by many individuals serving on local quotations committees and by various other standing committees.

At October 31, 1963, there were approximately 4,545 members of the association, and some 85,093 registered representatives of members.

The association's certificate of incorporation provides that its objectives and purposes, in part, are to—

> promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote high standards of commercial honor, and to encourage and promote among members observance of Federal and State securities laws.

The certificate of incorporation also requires the association to provide—

> a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business.

The association has the power to expel or suspend or impose other sanctions upon its members found guilty of violations of its rules of fair practice or of Securities and Exchange Commission rules.

The economic inducement for joining the association is set forth in the association's bylaws, which are based on section 15A(1) of the act and provide that no member shall deal with a nonmember broker-dealer except at the same prices and upon the same terms as such member deals with the public. This means, for example, that nonmember brokers and dealers cannot, as a practical matter, obtain underwriting discounts or commissions as participants in any distribution by members.

Detailed information upon the history and activities of the association is set forth in a reprint dated 1959 of the Subcommittee on Legislative Oversight of your committee.

On June 4, 1963, the Securities and Exchange Commission submitted H.R. 6789, which was introduced by Representativve Oren Harris, chairman of the House Committee on Interstate and Foreign Commerce. A companion bill, S. 1642, was introduced in the Senate on June 3, 1963, and was passed by the Senate.

In sending the bills to Congress on June 3, 1963, Chairman William L. Cary, of the Securities and Exchange Commission, stated in a transmittal letter that the legislative proposals are, in large part, based upon those sections of the report of the Special Study of the Securities Markets which were delivered to the Congress on April 3, 1963.

Chairman Cary also said that the Commission's aim was to present to the Congress legislation representing important advances which would be supported by the securities industry. Further, he noted that

the Commission has assurances of support from the leaders of the major securities organizations.

Our comments today, on behalf of the board of governors of the association, will be addressed to certain substantive provisions of the bill in the order in which they are presented in the six-page statement of the Commission which accompanied the bill.

The first area covered is that pertaining to the extension of the reporting, proxy, and insider trading provisions of present law to certain companies whose securities are traded over the counter. Under present law, these requirements extend only to companies whose securities are listed upon national securities exchanges.

It has been recognized for a number of years that the absence of financial reporting requirements in respect to over-the-counter securities has resulted in inadequate disclosures in some issues traded over the counter. The board supports the extension of the disclosure and reporting requirements to over-the-counter issues.

Our board wishes to note, however, that in an effort to prevent onerous reporting, proxy solicitations, and insider trading reports for smaller and less actively traded issues, the board would raise the stockholder test from the 750/500 level proposed by the Commission to a minimum of 1,000 shareholders before making operative the requirements now imposed upon listed companies.

We agree with the additional test in the bill that issuers required to report must also have assets in excess of $1 million. We note here that the Senate passed S. 1642 without changing the shareholder test. The association would prefer a 1,000-shareholder cutoff figure, but our support of the bill does not turn on this item.

The board of governors of the National Association of Securities Dealers, Inc., has been opposed to any blanket amendment to section 16(b) of the Securities Exchange Act of 1934 which would impose, without exception, the insider short-term profit recapture provisions to officials of companies traded over the counter.

The Securities and Exchange Commisison has recognized this viewpoint in section 8(b) of the proposed bill which provides, in new section 16(d) of the 1934 act, for an exemption from the operation of section 16(b) for broker-dealers who make markets in over-the-counter securities. The board, thus, supports this section of the bill in its present form.

We support the exemption of foreign securities from the requirements of this part of the bill. We note that should the Commission seek to remove the exemption in a given case, and to impose these requirements on securities of a foreign issuer, the procedures would afford opportunity to be heard before the Commission could make a finding.

In the event the Commission did find that the continuance of an exemption was not in the public interest, it is assumed that the Commission would afford to foreign securities covered by this bill the same exemptions now given to listed securities of a foreign issuer under rule 3(a)12–3 of the Securities Exchange Act of 1934; namely, exemptions from the provisions of sections 14 and 16 and from the requirement of filing current and semiannual reports. Such exemptions by the Commission could be accomplished by rulemaking and would not require legislation.

The second section of the Commission's statement deals with qualifications, standards, and controls of persons engaged in the securities buisness. The securities business has recognized, and it has been brought to the attention of a large segment of the investing public as a result of the Special Study, that presently there exists only a limited basis upon which the association or the Commission may bar inexperienced, undercapitalized, or otherwise unqualified persons from entering the business as proprietors or as employees of broker-dealers.

Over a period of years the association has concerned itself with this problem. One of its earlier recommendations was the imposition of a $5,000 minimum net capital for members dealing directly with customers. This recommended requirement was disapproved by the Securities and Exchange Commission in 1942 because, among other reasons, there was no express statutory basis for the rule. The legal foundation for such a rule is now presented for the first time in this bill, and would give the association the authority to write rules reacting to minimum capital requirements for its members. The board strongly supports this section of the bill and believes that proper minimum capital requirements can be developed and defined by the association whose rules must be reviewed by the Commisison and not disapproved.

As to qualifications of persons entering the business, the association has since 1956 imposed upon the new salesmen of its members a requirement that they pass an examination dealing with various technical, economic, and regulatory aspects of the securities business. This examination has been made progressively more difficult. Moreover, the association has lately developed new examinations and has coordinated with other groups its activities in the examination of persons entering the securities business. On December 1, 1963, the association will extend even more difficult testing requirements to members new to the business and their principals, before registering them with the association.

The board endorses the provision of the bill relating to qualifications as it provides the basis upon which the association may adopt additional safeguards for the public. The association will confer with the Securities and Exchange Commission and will correlate the information provided in chapter III of the Report of the Special Study in developing and adopting those rules considered desirable.

The provision of the bill incorporating the recommendation of the study report, which will require all broker-dealers to become members of a national securities association, whether this association or one to be organized, is supported by the board of this association. We agree with the purpose of this section of the bill and we believe to be worthwhile the extension of the self-regulation pattern to those not presently covered.

The sections of the bill which would allow direct action by the Commission against individual violators and which would allow proceedings by the association against individuals without the necessity for joining their employers in the action are considered to be helpful in the efficient handling of disciplinary matters.

We feel confident that the Commission will exercise this power in a manner that will serve to expedite proceedings against individuals while retaining full authority over their employers. In this regard, we expect the association to adopt new procedures under which it also

may proceed against individuals without the necessity of joining the employing member in the proceeding purely for technical jurisdictional reasons.

We welcome that section of the bill which would shorten the time period in which persons disciplined by the association can appeal to the Securities and Exchange Commission to 30 days. Since the appeal procedure is simple, the present period of 60 days has proved to be more time than needed and in many instances has served as a means of delaying the ultimate disposition of a case to the possible detriment of the public.

The board supports those other sections of the bill dealing with the broadening of the statutory disqualifications of brokers and dealers from registration with the Commission, the addition of intermediate sanctions against broker-dealers in Commission disciplinary proceedings, the elimination of the exemption for broker-dealers engaged in intrastate commerce in proceedings involving violations of the Securities Exchange Act of 1934 by broker-dealers.

The bill would add to existing law a provision stating that the association shall adopt rules pertaining to quotations of securities. The association presently disseminates retail quotations through its nationwide district and local quotations committees under the overall supervision of its national quotations committee.

Retail quotations of over-the-counter securities are supplied by the association to the major financial dailies as well as to almost all of the newspapers throughout the country that publish quotations of over-the-counter securities. The association has, since its inception, been concerned with the problems inherent in quotations of over-the-counter securities which involve a range of prices within which securities could have been traded on a given date.

The association is always seeking methods to provide informative and useful quotations in the over-the-counter market. We believe that section of the proposed bill pertaining to quotations to be a useful basis upon which the association may develop additional rules and procedures.

The board has no objection to the amendments to section 4(1) of the Securities Act of 1939 which would extend the requirements as to delivery of prospectuses for certain first issues from 40 to 90 days and would add a provision which would allow the Commission to shorten this period by rule or order.

We might comment here that we do not believe that this amendment will have much effect in preventing so-called hot issues, issues which command immediate premiums over the offering price. We support fully the permitted shortening of both periods by Commission action.

Over the past 2 years the association has been reviewing all provisions of its bylaws and rules in an effort to update and supplement them in areas where experience has proved the necessity therefore. We now have the completed Report of the Special Study and are attempting to correlate our study of our bylaws and rules with those recommendations contained in the Special Study.

We believe that the study shall be of material aid to us in forthcoming years in establishing those standards in the securities business which the public interest requires. We have already furnished this committee with an analysis of the association rules, the comments of the study

on them, and given our views, where formulated, on the recommendations of the study.

We strongly support the Commission's aims in this legislation and urge its prompt enactment by Congress.

Mr. STAGGERS. Does that complete your statement, Mr. Lemkau?

Mr. LEMKAU. Yes, sir.

Mr. STAGGERS. Thank you very kindly.

I would at this time like to say, Mr. Fulton, it is my understanding that this will be your swan song before this committee, inasmuch as you have announced your retirement next April 1, I believe, after many years of outstanding service with the association.

I express the regret of the entire committee at your departure. Over the years, by your unstinted efforts to launch, build up, and maintain the association at its high level of ethical conduct, you truly have become identified to us as Mr. NASD itself.

Mr. FULTON. Thank you very much, Mr. Chairman.

Mr. STAGGERS. Mr. Lemkau, I wish to thank you on behalf of the subcommittee for your fine statement on the legislation and for the reply you have submitted in response to the chairman's request of October 16. I would like to insert that letter and your reply in the record at this point.

Mr. LEMKAU. Thank you, Mr. Chairman.

(The documents referred to follow:)

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., October 16, 1963.

Mr. WALLACE FULTON,
Executive Director, National Association of Securities Dealers,
1703 H Street NW., Washington, D.C.

DEAR MR. FULTON: As you know, the committee has before it H.R. 6789, which I introduced at the request of the Securities and Exchange Commission, and S. 1642, the companion bill, which has already passed the Senate, which embody legislative recommendations of the Commission growing out of the 2-year study it made pursuant to House Joint Resolution 436, 87th Congress, into the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations.

As of this date, we have not yet set a date at which we will have hearings upon this proposed legislation, but it is my intention to have hearings thereupon when the schedule of the committee's activities so permits. I am sure that you appreciate that inasmuch as the Commission's study was initiated and sponsored by this committee, the committee feels it incumbent upon it to consider this proposed legislation. At the time the legislation is considered, however, it is the committee's intention to review the recommendations of the Commission as to legislation and as to what should be done under rulemaking powers, and also as to the Commission's Special Study findings on the adequacy of the rules of the exchanges and of the securities associations for the protection of investors.

In this connection I am sure that you already have given attention to the Commission's expressions and to the findings of the Commission's Study Group with respect to the adequacy of the various rules which you have enunciated as well as to some which might be deemed appropriate to be promulgated.

I am writing this letter to you accordingly in anticipation of the hearings which we shall have on the legislation and the study, and of your appearance before the committee at that time expressing your opinion thereupon so as to make sure that you develop in your appearance, if not before that time, your analysis of all of your rules and the comments of the Commission and of the Study Group on each of your rules as to the adequacy of each rule, for the protection of investors, and the suggestions of what additional rules should be considered by you.

Sincerely yours,

OREN HARRIS, *Chairman.*

REPLY OF NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., TO LETTER DATED OCTOBER 16, 1963, FROM HON. OREN HARRIS, CHAIRMAN OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE OF THE U.S. HOUSE OF REPRESENTATIVES, NOVEMBER 18, 1963

On October 16, 1963, you wrote the association that your committee would soon be considering the legislative recommendations of the Securities and Exchange Commission embodied in H.R. 6789 and S. 1642, the companion bill which has passed the Senate. You asked in your letter that, at the time of the hearings on H.R. 6789, the association express its opinion on the legislation and the study and at the same time, if not before, that we furnish you with an analysis of all of the association's rules and the comments of the Commission and of the study group on each of these rules as to their adequacy for the protection of investors, as well as suggestions of what additional rules should be considered by you.

The very size and scope of the Special Study report, the fact that comments on the association's rules are interwoven in many sections of the report, and the breadth of the report make it difficult, in the short time which has elapsed since the whole report has been publicly available, to obtain the reaction of those in the securities business throughout the country and to allow for the full and careful study by the board of governors. Such careful study is necessary on many of the recommendations in the report before the board could properly express final rejection or acceptance of them, in whole or in part, although we have taken certain concrete steps and obtained tentative reactions as to some of them.

When the association speaks of its rules it means its rules of fair practice, particularly the 28 sections of article III and the interpretations adopted. When the special study refers to association rules it includes these rules of fair practice, interpretations and some of the association's bylaws which contain substantive requirements. Accordingly, for purposes of this response, we will consider our rules of fair practice, interpretations under them and those sections of the bylaws which relate directly to the protection of investors or are the subject of specific comment by the study.[1]

Article I. Membership[2]

BYLAWS

Section 1: This section provides for admission to the association of any broker/dealer transacting a securities business under the laws of any state and/or the laws of the United States unless ineligible under section 2 below.

Section 2(*a*): This subsection sets forth the restrictions on admission to membership which generally relate to ineligibility caused by suspension or expulsion from the association, by the Commission or a securities exchange or conviction within the preceding 10 years of a felony or misdemeanor involving a security or the conduct of the business of a broker/dealer or embezzlement, fraudulent conversion, misappropriation of funds, or abuse or misuse of a fiduciary relationship.

(*b*) This subsection provides for a minimum experience requirement of 1 year in the securities business or the taking of a written examination prescribed by the association.

Section 3 contains various definitions; section 4 relates to the form and content of an application for membership and the processing of the application by the association; section 5 requires that each member appoint an executive representative who shall represent, vote, and act for the member in its dealings with the association; section 6 deals with the requirement that the association keep an accurate and complete membership role; section 7 provides for resignation of members; section 8 controls transfer of membership; and section 9 provides for the registration of branch offices.

Section 10: This section relates to the vote of branch offices; section 11 defines branch office; section 12 calls for classification of branch offices; and section 13 provides for a proceeding for determining ineligibility or for summary cancellation of membership upon the existence of a disqualification with ultimate review of such action by the Securities and Exchange Commission.

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[1] Reprints of the association's manual containing the rules of fair practice, bylaws, interpretations, code of procedure, uniform practice code, and other matters are being supplied with this reply.

[2] Association's bylaws, manual, pp. C5–61.

Article I of the bylaws is the article which controls the admission to membership. The subject of admission to membership and qualification of persons in the securities business is discussed at length in chapter II of the Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, part 1.[3]

Chapter II. Qualification of persons in the securities business

Chapter II examines the standards and controls relating to the entry into and removal from the business of broker/dealers, salesmen, and persons engaged in giving investment advice and their activities and responsibilities in the course of that business.

Discussing the association, the study notes that membership in the association is not a legal requirement for engaging in the securities business but that the rules of the association, sanctioned by Federal law, preclude a member from dealing with a nonmember broker/dealer except on the same terms and conditions as those employed in dealing with the public.[4] The study notes that the requirements of membership in the association up to 1956 were substantially identical with those imposed by the Commission in registering with it as a broker/dealer. Since 1956 the association has expanded the grounds prohibiting entry in the business to cover persons convicted of certain crimes and has imposed examination requirements for those who did not meet minimum experience requirements in the business. The information obtained by the association on its application form, the study states, is presently more extensive than that required by the Commission on its broker/dealer form. The study report noted that the association endeavored in 1942 to require minimum net capital of $5,000 for members dealing directly with the public and $2,500 for those who did not. This proposal was disapproved by the Securities and Exchange Commission on the grounds that a requirement for minimum net capital would not constitute an appropriate basis for determination of membership under section 15A(b)(3) of the Exchange Act.[5]

Concerning association control over salesmen, the study report noted that the association has a rule which provides that a member shall have reason to believe upon the exercise of reasonable care that a person is of good character and business repute and is qualified by training to perform his duties.[6] The study group notes that in 1962 the association entered into discussion with the New York Stock Exchange and National Association of Securities Administrators to develop joint or coordinated examination programs in an effort to eliminate duplication in the taking of these examinations.[7] The study states that the examination instituted by the association in January 1962 represents an advance over its previous examination and that the basic instrument for assuring the public that a salesman has a reasonable minimum of competence must continue to be the examination.[8]

The study recognizes that future licensing programs should consider the different competence and needs of salesmen of different kinds of securities but it notes that such limited registration, for example to those who sell mutual funds, should insure that the individual so limited "not be free to sell securities of any other kind."[9]

The study group had 12 specific conclusions and recommendations under this chapter of the report.[10] In the comments of the Securities and Exchange Commission itself as distinguished from the Special Study Group, Chairman Cary in his letter to Congress of April 5, 1963, stated that the Commission was in agreement with all 12 conclusions and recommendations and that 9 of these recommendations are the basis of legislative proposals with the remaining 3

[3] "Report of Special Study of Securities Markets of the Securities and Exchange Commission." (This report will hereinafter be referred to as "Report of Special Study"), H. Doc. 95, pt. 1, p. 5. The first part of the special study report covering chs. I, II, III, IV, and IX was transmitted to the Congress on Apr. 3, 1963. The second part of the study report covering chs. V, VI, VII, and VIII was transmitted to the Congress on July 17, 1963, and the last part of the study report covering chs. X, XI, XII, and XIII was transmitted to the Congress on Aug. 8, 1963. The first volumes of these various parts transmitted to Congress were available in extremely limited supply. The full study group report has since been published as H. Doc. 95, pts. 1, 2, 3, and 4. The last part of the report transmitted on Aug. 8, 1963, was made available by the Government Printing Office on Oct. 24, 1963.

[4] H. Doc. 95, pt. 1, p. 72.

[5] Id. at 87.

[6] Id. at 117.

[7] Id. at 120.

[8] Id. at 155.

[9] Id. at 157.

[10] Id. at 159–162.

being items which could be handled under rulemaking authority.[11] Since 9 recommendations of the 12 mentioned in Chairman Cary's letter were the subject of consultation and consideration by industry and the Commission prior to the submission of H.R. 6789 and S. 1642 and the association position in support of H.R. 6789 is being filed with the House in a separate document, we will confine our remarks, in the interest of space, to the three recommendations not considered prior to the submission of the legislative proposals.

Recommendation No. 3 relates to the study group's conclusion that the Securities and Exchange Commission broker/dealer forms need to be changed to require additional information. When and if the Commission takes this administrative step, the association will give consideration to any changes in its own application form made desirable by the change in the broker/dealer form.

Recommendations Nos. 11 and 12 relate to minimum net capital requirements to be adopted by the Commission and/or the association. The bills before Congress propose to give the association the authority to write rules relating to capital requirements for its members. The Commission will presumably implement this recommendation and adopt a minimum net capital requirement under its own rules. The association will be guided in the actual specifics of any capital rule adopted by it by any proposed net capital rule to be adopted by the Securities and Exchange Commission, pursuant to this recommendation, after opportunity for comment by the industry.

The board has spent considerable time discussing the actual capital requirements which might be employed in a rule to be adopted. It has concluded that the suggested minimums of $5,000 and $2,500 of the Commission study report under recommendation No. 11, while modest, are perhaps the maximums feasible at this time.[12]

A review of the capital of our members indicates that if the requirement were minimum net capital of $5,000, about 25 percent of the membership would not qualify but, of course, it is impossible to determine how many members would continue to operate by raising additional capital within a time period to be prescribed by the board to comply with any new rule. The board is aware of the difficult balance on the matter of such requirements between insuring, at least to a minimum extent for the protection of the public, the capital soundness of a member and precluding those less financially able, however capable and scrupulous, from entering or continuing in the business.

The suggested capital for those in underwritings contained in recommendation No. 12 is one which will be discussed with the Commission staff as to dollar amounts and definitions prior to adoption of any rule by the association or at hearings upon any proposal for such a rule by the Commission.

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[11] After the first part of the Special Study Report was transmitted to Congress and made available to industry organizations, the Commission asked for the association's and other groups' views on proposed legislation. In order to report the association's views concerning the first part of the study report to the Securities and Exchange Commission in connection with its legislative proposals, the association held a special board meeting in April 1963 and later devoted a substantial part of its regularly scheduled May 1963 board meeting to consideration of the proposed legislation which resulted eventually in the enactment by the Senate of S. 1642. Not every feature of the nine recommendations was embodied in this bill.

After the association appeared on June 19, 1963, before the Senate in connection with S. 1642, the second two parts of the Special Study Report became available and the association has been studying these since their release to the public. The first board meeting after the complete report (pts. 1, 2, 3, and 4) was available to the association was held in September 1963 when various parts of the study report were discussed at length and other parts considered within the time limits of the board meeting.

Since the release of the first part of the study report the association has been constantly engaged in review of the conclusions and recommendations in consultations with those in the business expert on a given subject, in meetings of the board and of committees of the board and conferences with the staff of the Commission. However, because of the scope of the study, and the short amount of time which has elapsed since its availability the board has only been able to review most of the matters covered by the study on a preliminary and tentative basis. Specific committees have been appointed since the September 1963 board meeting to review various aspects of the Special Study Report at length with instructions to report to the board of governors as soon as possible consistent with a reasoned and complete recommendation. It is not contemplated that these various committees which have been assigned areas of study which are extremely broad in scope will be in a position to give more than preliminary reports in the ensuing months.

[12] Our studies indicate that approximately 44 percent of our 4,624 members as of Aug. 31, 1963, are located in States which have mandatory net capital provisions, approximately 73 percent are located in States having either mandatory net capital or bonding provisions and that less than 26 percent of our members are in States where there are no requirements or where the statutory requirements have not been implemented.

Articles II. Affiliates

This article of the bylaws relates to affiliation with the association of other associations of brokers or dealers.

Article III. Dues, assessments and other charges

This article provides for the board's fixing assessments, changing the schedule of assessments, canceling membership for nonpayment of dues, or assessments, reinstatement of membership, and the maintenance of a list of members disclosing dues paying classifications.

The study report discusses the association's fiscal policy and planning in the subchapter on the association organization.[13] Later in this subchapter the study noted that the association's 1964 budget approved in June 1963 provides for expenditures in excess of $3 million for the first time in the association's history and upward adjustments have again been made in the assessment and fee schedules to support increased expenditures.[14]

Article IV. Organization and administration

Section 1: This section provides for a geographical division so that there is fair representation of the membership.

Section 2 defines the powers of the board of governors; section 3 sets forth the representation of the board of governors from the 13 association districts; sections 4, 5, 6, and 7 relate to election to the board and term of office; and sections 8 and 9 provide for meetings of the board and officers of the association.

Sections 10 through 19 make comparable provisions for district committeemen.

The organization and structure of the association is considered at length by the study[15] and the recommendations of the Study Group adopted by the Commission are that the association give consideration to ways and means of obtaining a better distribution of seats on district committees and the board of governors by size and type of firm, that the association explore the possibilities of having a limited number of governors at large to correct geographic imbalance or to provide functional representation for a particular class of firms.

Article V. Officers and employees

This article provides for officers of the board, executive officers, employment of counsel, administrative staff, district secretaries, and various committees. These matters are considered by the study under the heading "NASD Organization and Functioning."[16]

In its recommendations, the study suggests that consideration be given by the association to realinement of the functions and responsibilities of member officials, paid staff, with an increase in the size, stature, and responsibility of the latter, and the placing of more emphasis on committees of the board, particularly the national business conduct committee in order to relieve the board from certain disciplinary responsibilities and to provide the board with more time to consider policy.[17]

At the September, 1963 board meeting a special committee of the board, composed of two board members and two ex-board members, was assigned the responsibilities to review the recommendations in chapter XII(G), relating to organizational changes which include the subject of disciplinary procedures. Because of the scope of this assignment the board has no preliminary report from this committee nor does it expect one in the immediate months ahead but the board is aware of the need for a thorough study of its organization and the functions of its staff and the latter's role as contrasted with that of volunteer officials from the securities business.

Article VI. Committees

This article gives the board and district committees the power to appoint various standing and other committees.

Article VII. Rules of fair practice

This article provides for the adoption by the association of rules of fair practice designed to promote just and equitable principles of trade, provides for amendment to the rules after submission to the membership for a vote and if not disapproved by the Securities and Exchange Commission under section 15A of

[13] H. Doc. 95, pt. 4, ch. XII–G, pp. 641–646.
[14] Id. at 672.
[15] Id. at 607, 641.
[16] Id. at 608, 641.
[17] Id. at 679, 682.

the Securities Exchange Act, provides for the adoption by the board of governors of interpretations of the rules, requires that the association provide for procedures in handling disciplinary complaints, permits the association to adopt penalties for infraction of its rules or bylaws by members or registered repesentatives and sets forth the requirements contained in section 15A of the aforementioned act which must be followed in any proceeding to discipline a member or registered representative. This article is the basis in the bylaws for the adoption of the Rules of Fair Practice contained in the association's manual, section D and the Code of Proceure for Handling Trade Practice Complaints contained in the association's manual, section E.

Article VIII. Limitation of powers

This article relates to the limitation of powers, article IX to amendments to the bylaws and article X through article XIII relate to certain corporate requirements and procedures.

Article XIV. Uniform practice code

This article is the bylaw basis for the association's Uniform Practice Code. The study, in commenting on this code, states that the association has elaborate rules with respect to transfers of securities and that problems which arise in the area of such transfers have concerned the association's uniform practice committee for a number of years. The study discusses the proposals of this committee in 1961 to reduce the volume of "fails." These were to increase the use of the buy-in procedure, reduce the number of trading hours and revise the Uniform Practice Code to permit "marking to the market" on all transactions. The board of governors did not accept these recommendations of its committee but promulgated a notice urging its members to suspend trading on May 29, 1961, and to devote that day to reducing the "fails" situation.[18]

The study also points to the part the association played in establishing the National Over-The Counter Clearing Corp., which initially will be confined to New York City, the facilities of which should serve to limit the number of "fails."[19]

The study sets forth four conclusions and recommendations on this section of its report: (1) the association should adopt rules permitting "marking to the market" on a greater range of contracts than now covered; (2) the self-regulatory organizations should consider mandatory buy-ins for various types of markets or categories of securities; (3) the association should adopt rules which would permit the board to establish hours of trading; and (4) the industry with the cooperation of the Commission should give continuing attention to possibilities for modernizing and improving existing securities handling, clearing, and delivery systems.[20]

Chairman Cary in his letter to Congress states that the Commission agrees with the four conclusions and recommendations and will lend support to the industry and self-regulatory organizations in giving the proposal careful consideration. The association questions the practicality of establishing hours of trading in the over-the-counter market which is not a market comparable to exchange markets but as to this and the other three recommendations the board will study them in conjunction with its already commenced review of its Uniform Practice Code.

Article XV. Registration of Registered Representatives

This article gives the association jurisdiction over salesmen, provides for their registration with the association, the resignation or termination of such registration and gives the association jurisdiction for purposes of disciplinary proceedings provided, that in any complaint action, a member of the association is also joined. Under the proposed legislation, if it becomes law, the Commission would be permitted to proceed in enforcement actions against individuals in the securities business and the association, after appropriate amendment of its bylaws, would be given similar authority.

As noted in the study report under the heading "Recent Developments" the association has, since September 1961, been undertaking a complete review and analysis of its by-laws, rules, and interpretations.[21] In connection with this

[18] Supra note 4 at 422.
[19] Id. at 424.
[20] Id. at 428.
[21] Supra note 13 at 671.

revision, it is the association's plan to consider the various comments and suggestions of the study as they relate to matters which properly come under the 14th articles of the bylaws. With the exception of article I which relates to admission to membership most of these bylaws relate to the organization of the association which is the subject of thorough study by the committee appointed at the September 1963 board meeting. Most of the tentative changes made to date in the bylaws as a result of the association's own revision involve clarification, modernization, and efforts to achieve a more efficient administration of the association's affairs.

RULES OF FAIR PRACTICE

Article I. Adoption and interpretation

This article provides for adoption of rules and makes clear they shall not apply to transactions in exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934.

Article II. Definitions

This article contains definitions of certain words or terms used in the rules.

Article III. Rules of fair practice

This article contains the 28 rules of fair practice which, taken together with the interpretations and resolutions of the Board adopted under these 28 sections, are the substantive rules of the association.

Section 1: This is the keystone rule of the association and it contains the overall requirements which all rules and interpretations of the association seek to impose upon a member; i.e., than in the conduct of his business a member shall observe high standards of commercial honor and just and equitable principles of trade. Under this foundation section of the rules, the Board has adopted various interpretations.

MARKUP POLICY [23]

One of the principal interpretations adopted under this section and section 4 of this article, known familiarly as the markup policy, provides that in a transaction between a member and a customer a member must buy or sell at a price which is fair under all the circumstances and in an agency transaction charge no more than a fair commission or service charge. The study considered this markup policy in detail, the background of its adoption, an explanation of the policy, commented on its application and concluded that the policy is not thoroughly understood by the membership or uniformly interpreted by the association. The study stated, however, that its enforcement has added to the protection of investors in certain areas and has served "an important purpose in preventing excessive spreads in retail quotations and in setting outer limits of permissible retail pricing." [23]

The study in a specific recommendation, with which the Commission agreed, sugested that this policy be clarified and strengthened. The Board, in connection with revision of its own bylaws will work to clarify the interpretation, both for purposes of administration and for future guidance to the membership.

ADVERTISING POLICY [24]

The next interpretation adopted under section 1 relates to advertising and prohibits a member in any sales promotional material or in the recruitment of personnel from employing come-on techniques or making statements which are flamboyant or misleading.[25] The study states that this broad general rule has not had a significant impact on the industry.[26]

In its recommendations the study suggests that the association adopt standards governing the representation of its members as to their investment advisory capacities, that the association establish procedures to review sales literature and market letters so as to eliminate reckless dissemination of written investment advice. The Commission in its transmittal letter to Congress indicated that it was in agreement with these recommendations. The Board of Governors

[22] NASD manual, pp. G–1–6.
[23] H. Doc. 95, pt. 2, p. 668.
[24] NASD manual, pp. G–19–20.
[25] Literature used in selling investment company shares is discussed later herein when considering sec. 26.
[26] Supra note 4 at 379–381.

appointed a special committee in 1962 to review the association's policy on advertising and selling literature. This committee has met with the staff of the Commission on two occasions and will report to the Board of Governors at its January 1964 meeting with specific suggestions for improvement of the existing interpretation on advertising.

INTERPRETATION WITH RESPECT TO "FREE-RIDING AND WITHHOLDING" [27]

This interpretation also adopted under article III, section 1, of the Rules of Fair Practice was discussed by the study in chapter IV which relates to distributions to the public. This interpretation places an affirmative duty on a member which has acquired securities in connection with a distribution to make a bona fide public offering of these securities so that there is no withholding of premium issues from the public except under specific conditions where those who qualify as insiders may purchase so-called "hot" issues if the purchases are consistent with their investment practice and the total purchases by such insiders are not disproportionate nor substantial compared to shares sold to members of the public.

The study concluded that the interpretation had not seemed effective, for one reason because of the inadequacy of penalties imposed in cases involving "free-riding" violations.[28] The study suggests that the association strengthen its "free-riding" interpretation by requiring additional reports and increasing the degree of sanctions imposed for violation so as to constitute a real deterrent. The association believes its enforcement of the "free-riding" interpretation has been more effective than the study group found and it believes the interpretation, perhaps with minor areas of clarification not discussed by the study group, is basically effective. Originally the association's concept of penalties was to "fine away" the profit of a firm or insider-purchaser involved. This was later broadened in flagrant cases to suspension or revocation. We will, however, review the conclusions of the study with the staff of the Commission and give consideration to the comments contained in this recommendation.

REVIEW OF UNDERWRITING ARRANGEMENTS

Under article III, section 1, the association has adopted a procedure for review of underwriting arrangements [29] which is designed to put the membership on notice that underwriting compensation deemed unreasonable by a District Business Conduct Committee would be the subject of disciplinary action by the association. The study, in commenting on the association's activities in the review of underwriting arrangements, states that this is a matter which self-regulatory agencies can deal with effectively.[30] In its recommendations at the conclusion of chapter IV the study suggests that the Committee on Underwriting Arrangements publish summaries of its conclusions so as to give guidance to the membership. To publish the conclusions of its Committee at this time would seem to the Board to lead to the impairment of its program of preventing unreasonable compensation. It is believed that no set percentage limits should be promulgated and that each case should be considered in light of the individual circumstances involved. If specifics were given even when related to offerings where the Committee had deemed the compensation unreasonable, there might be a tendency on the part of some underwriters to seek to charge always the maximum possible.

Some of the various other interpretations adopted under article III, section 1, were the subject of comment by the study group, but no specific recommendation was made to change these interpretations, and the association believes they are effective.

The association also enforces regulation T of the Federal Reserve Board [31] and the Securities and Exchange Commission net capital rule under section 1.

REGULATION T

The provisions of regulation T applicable to special cash accounts require that customers pay for securities purchased within 7 days after the date of purchase

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[27] NASD manual, pp. G–23–26.
[28] Supra note 4 at 533. See also comment at p. 556.
[29] NASD manual, pp. G–59–62.
[30] Supra note 4 at 512.
[31] NASD manual, pp. I–1–7.

unless extensions of time are granted, which extensions may be granted by district offices of the association. Violation of regulation T is the most prevalent charge found in association disciplinary proceedings.[32]

NET CAPITAL RULE

Compliance with the Commission's net capital rule (rule 15c–3 under the Exchange Act) is an area stressed in periodic examinations of association nonexchange members, and the study states that it is the association's policy to promptly notify the Securities and Exchange Commission when a net capital rule violation is uncovered. The study notes that violation of article III, section 1, as a result of violations of the net capital rule, were found in over 100 cases in the 3-year period from 1959 to 1961.[33]

Section 2: This section requires that recommendation to a customer covering the purchase, sale, or exchange of any security be only made by a member who has reasonable grounds for believing that the recommendation is suitable for the customer based upon the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. The Study discusses this rule of the association and states that it has a far-reaching potential for dealing with improper selling practices and, for the most part, the association has interpreted the section in ways which strengthen its impact.[34]

The study has a specific recommendation concerning this rule, No. 4 at the conclusion of subchapter (b) of chapter III,[35] with which the Commission agrees. This recommendation suggests that the association further define the content of this section or the so-called suitability rule and provide for more effective enforcement of it. The association believes this is a difficult concept to delineate, but in connection with its general review of these recommendations will study this further.

Section 3: This section relates to service charges and is not specifically discussed by the study and is seldom the subject of allegations in association disciplinary proceedings.

Section 4: This section relates to markups in principal transactions and commissions in agency transactions and this section is the basis, along with article III, section 1, of the association's markup policy discussed above.

Section 5: This section states that no member shall publish or circulate any communication which purports to report any transaction as a purchase or sale of a security unless the member believes such transaction was bona fide and in connection with a quotation of the bid or asked price of a security unless the member believes such quotation is bona fide. If nominal quotations are used they shall be clearly stated as such.

The Board has adopted an interpretation on manipulative and deceptive quotations which is based upon this section and section 18 of article III and in connection with the implementation of this resolution has instructed the membership that the Board believes that the interests of the investing public and securities business can best be served when the quotations are supervised by the association.[36]

Section 6: This section prohibits a member from making an offer to buy or sell a security unless the offer is firm. This section has been seldom used in disciplinary proceedings but is related to activities discussed by the study and considered below in the recommendations under chapter VII.

The subject of quotations is considered at length by the study in chapter VII entitled "Over-the-Counter Markets." The NASD role in supervising retail quotations is discussed under subchapter D of chapter VII.[37] On the specific subject of manipulative quotations the study notes that fictitious quotations have been inserted in the National Quotation Bureau sheets to facilitate illegal distributions of stock or to manipulate the aftermarket price of a new issue.[38] The study group had 16 recommendations at the conclusion of chapter VII and certain of these relate generally, if not specifically, to matters covered by article III, section 5.

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[32] Supra note 13 at 53.
[33] Id. at 655.
[34] Supra note 4 at 311.
[35] Id. at 329.
[36] NASD manual, p. G–53.
[37] Supra note 23 at 631–645.
[38] Id. at 605–609.

1. The first recommendation discusses the need for some control or regulation over operators of interdealer quotation systems. This is a matter which was considered by the Securities and Exchange Commission in connection with its current legislative proposals and it is our impression that the Commission is still studying possible legislation or other alternatives in this area. The Board believes, on the general subject of control of quotations, that the association should take increased responsibility. Present legislative proposals (H.R. 6789 and S. 1642) will provide for the association's adoption of additional rules in this area to fulfill these responsibilities when the prospective roles of the quotations operators, the Commission and the association are clarified in future discussions.

2. The study next suggests that broker-dealers be obligated to perform at quoted prices for the number of the shares indicated in the quotation and should be required to keep time records of changes in quotations. Further, the study suggests that the Commission and/or association should have the power to suspend any broker-dealer's right to enter quotations where the broker-dealer has willfully abused the quotations system.

Chairman Cary states that the Commission agrees that certain practices discussed in chapter VII appear inimical to the public interest and require better or additional controls on the part of the regulators. The association's section 6 requires that broker-dealers inserting quotations must do so only when they fully intend that these quotations be firm at the moment given (unless designated otherwise). The Board does not believe it practical from an operational standpoint for broker-dealers to keep time records of changes in quotations. The Board will explore with the Commission the last suggestion in recommendations No. 2 that the association or Commission should have the power to suspend a broker-dealer's right to insert quotations when the broker-dealer has been found to have abused the quotations system.

3. The study suggests that other rules applicable to interdealer quotations should require:

(a) That quotations entered by a broker-dealer on behalf of another be so designated. Chairman Cary, writing for the Commission, agrees on early implementation of this recommendation and the Board's initial reacto this proposal was favorable.

(b) That OTC listed securities mentioned in chapter IX be differentiated from all other securities by appropriate symbols. Action in this regard would depend upon the passage of the proposed legislation which would extend the present reporting requirements, proxy rules, and insider trading reports to certain issuers whose securities are now sold over the counter and then it would be necessary to distinguish such securities sold over the counter from those sold over the counter where similar information was not available to the public. Since this recommendation depends upon bills in Congress, the Board has not considered it except to note that "OTC—Listed" would be an undesirable designation for such securities. This is a point to which the Study Group gives recognition in the third part of its report where it discusses security credit.[39]

(c) The study recommends that broker-dealers be required to make available to their regular customers any quotations system to which they may be subscribers. The second part of recommendation (c) suggests that there be a system for identification of primary marketmakers and that such primary marketmakers have the exclusive right to enter two-way quotations in any interdealer quotations system. Chairman Cary in his letter to Congress points out that as to the recommendations contained in 3(c) the Commission is not prepared to determine at this time which of the proposed changes should replace the present concepts followed by the business. The reaction of the board of governors to the proposals in 3(c) was that the thrust of the suggestions was somewhat impractical, that it would drastically and injuriously alter the present system of doing business in the over-the-counter market and it would bar a dealer with a buy and sell order from two separate customers from publishing such orders. However, the association is continuing to discuss these recommendations with the Commission.

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[39] Supra note 13 at 21. The study states that since ch. IX was published it has been suggested that the particular designation of "OTC—Listed" could be unfortunate because of possible confusion with securities listed on a stock exchange. The study suggests alternative designations such as "OTC—Special," "OTC—Disclosure—Listed," "OTC—Registered" or "OTC—Public."

4. Recommendation No. 4, in brief, calls for the registration of primary marketmakers and for the association to make available for public inspection an official primary market list. The Commission position as to No. 4 is that, at this juncture, it would be impossible for the Commission to judge with assurance the total effect of some of these suggestions and that this is an area for discussion between the Commission staff and industry. The association is discussing this and other matters with the Commission staff, but the board's tentative reaction to the suggestions in recommendation No. 4 is that the proposals would constitute a vast amount of recordkeeping without any clear indication that such information would benefit the public. It would, furthermore, seem clear that a primary marketmaker would be free at any time to withdraw from the market upon giving the notice which would be required and that nothing significant would be accomplished by such a requirement.

5. Recommendation No. 5 calls for the Commission and association to make it a part of their "continuous agenda" to seek to strengthen the mechanisms of interdealer markets particularly in the light of the possibilities of automation, to consider future rules, interpretations or statements of policy concerning the rights and obligations of primary marketmakers, the granting of "cheap" stock, warrants or options to such marketmakers, supervision over and compensation of traders and other matters. Chairman Cary states that the Commission will consider with the association the subjects raised in item No. 5. The association has a special committee studying possible use of automation in the over-the-counter market and will continue to consult with the Commission staff.

6. In this recommendation the study suggests the adoption of rules requiring that broker-dealers execute transactions after obtaining the best information on the market so as to provide an execution most favorable to the customer under given market conditions. The Commission in its letter to Congress listed this item under those which should be considered promptly by the Commission and association and the initial reaction of the board of governors to the suggestion is that such a rule is unnecessary as the presently highly competitive nature of the business now brings a great efficiency to these executions and that a broker-dealer who does not obtain the most favorable execution for its customer loses him to a broker-dealer whose performance is better.

7. Recommendation No. 7 concerns the execution by a broker-dealer in various capacities. The study suggests that in a riskless transaction, i.e., where the broker-dealer is not a primary marketmaker nor has a bona fide inventory position, customers' orders be executed on an agency basis. The board's position is that such proposal might well prevent a dealer in areas outside of large cities from operating on a profitable basis, and this problem is effectively dealt with by virtue of competitive conditions. In our opinion, if New York Stock Exchange auction market commissions were to prevail some percentage of the dealers, both in and outside of metropolitan areas, would be forced from the business. Thus, customers would no longer have available many of the dealers which are a part of their communities which have traditionally provided them with personalized services.

9. The study suggests that the present system of retail quotations furnished by the association should be supplanted by a system designed to show the best prevailing interdealer bid and asked quotations and the number of primary marketmakers for each security. The study states that by appropriate explanatory legends and by association sponsored educational efforts the investing public should be advised that published quotations are interdealer quotations rather than retail quotations and, hence, are subject to markups, markdowns, or commissions in retail transactions.

Chairman Cary in his letter to Congress states that this recommendation is in the category where the Commission is not prepared, on the basis of the work so far done, to determine what concept should replace that presently in existence.

The board believes that the publication of wholesale markets would destroy established merchandising concepts in the over-the-counter market and drastically affect the liquidity and depth of markets in many securities issues. The matter of published quotations is No. 1 on our priority list of problems raised by the Study Group, it has involved many committee meetings to date and so far we have reached no final conclusions.

10–11. Recommendation Nos. 10 and 11 relate to the association's method of handling local quotations and in improving its retail quotations system in certain respects. Chairman Cary in his letter to Congress states that the Commission agrees with the Study Group on these recommendations, both of

which recommendations are now being worked upon and implemented by the national quotations committee of the board and staff of the association.

12. Recommendation No. 12 relates to "OTC—Listed" securities concerning which see the comment on recommendation No. 3(b) above.

13. Recommendation No. 13 calls for the association and/or Commission to reexamine the present requirements with a view to improving disclosures at the time of soliciting a retail purchase or in confirmations in, among others, the following three specific ways:

(a) A broker-dealer soliciting a customer's purchase of any security for which there is no independent market other than its own, or for a security out of its own inventory or a security where the spread is 20 percent or more between the bid and offer should make a disclosure of such facts prior to solicitation.

(b) The confirmation of a customer's purchase or sale involving 100 shares or less if handled on a principal basis should be required to show the wholesale quotation, i.e., the wholesale bid in the case of a customer's sale or asked in the case of a customer's purchase.

(c) The confirmation of a purchase should show a representative bid.

These recommendations fall under the category which requires further consideration by the industry and extensive discussions with the Commission staff.

Section 7: This section sets forth requirements for certain information in selling group agreements. In connection with the revisions of the association's bylaws, this section will be dropped as present business practices often do not involve formal selling group agreements and, in fact, any oral or written agreements would contain the information called for by this section. (See sec. 26(c) below where this requirement must be met by members' underwriting investment company shares.)

Section 8: Section 8 requires that when a member, participating in a distribution of an issue, takes securities in trade he must purchase such securities at a fair market price or sell them for the customer on an agency basis. This section merely states the same requirement of fair dealing which is embodied in section 4 considered above and the association's markup policy.

Section 9: This section puts a member on notice that he must never use, for soliciting purchases or sales, information as to the ownership of securities which is obtained by the member through its activities as a trustee or in a similar capacity. It has been seldom necessary to use this section of the rules.

Section 10: This section states that no member shall give anything of value to any employee of another person for the purposes of influencing or rewarding that person for services rendered unless this is done with the prior knowledge and consent of the employer. This section was found several years ago to be ineffective in connection with the sale of "hot" issues to institutional buyers.

The association's "Interpretation With Respect to 'Free-Riding' and Withholding" was rewritten in 1960 to prohibit these practices which could not be reached by section 10. Except for "free-riding" situations which arose prior to 1960, this section, which is a standard prohibition against an improper commercial practice, is seldom used in disciplinary proceedings. If proved, it would result in immediate expulsion or revocation.

Section 11: This section prohibits a member from giving anything of value to any person for the purposes of influencing or rewarding the action of such person in connection with the publication in a news media, investment advice or similar publication of any matter which has, or its intended to have, an effect upon the market price of any security. This section does not apply to paid advertising. This section has very seldom been used as the basis for disciplinary action.

Sections 12, 13, and 14: Section 12 is an important section of the rules and states that at or before the completion of a transaction with a customer, a member shall give or send to such customer a confirmation of the transaction which indicates in writing the capacity in which the broker or dealer is acting and, depending upon the capacity, certain information. Section 13 requires that a member, before executing a trade, disclose any control relationship he might have with the issuer of a security. Section 14 calls for disclosure by a member of any interest he may have in a distribution of securities he is selling to his customers. These rules are based on Securities and Exchange Commission rules 15c1–4 through 15c1–6 under the Exchange Act. Disciplinary proceedings under section 12 are frequent but under sections 13 and 14 are rare and the study notes that procedures for detecting violations of sections 13 and 14 are not defined.[40]

[40] Supra note 13 at 656.

The study's recommendations as to disclosures are considered above herein under the recommendations in chapter VII relating to quotations.

Section 15(a): This section states that no member shall permit, in an account over which the member has discretionary power, transactions which are excessive in size and frequency and that in handling a discretionary account the member shall keep certain records concerning these transactions. This section is used by the association to prevent "churning," i.e., overtrading, in a discretionary account. The association has no present rule requiring that a member obtain written customer authorization for the opening of a discretionary account, but in its revisions of the rules the board is considering the adoption of such a rule. The study states that enforcement of this section, as well as section 2 discussed above which is used for a "churning" case in an account which is not discretionary, has suffered because examiners seldom interview customers and because the association examiners are unable to devote adequate time to analyzing accounts for possible violations.[41] These critical comments will be considered in connection with the overall review of the association's disciplinary procedures and organizational changes.

Section 16: This section prohibits a member participating in a distribution from making a representation that the security being offered to a customer is being offered "at the market" or at a price related to the market unless the member believes that a market for the security exists other than that made or controlled by the offering member.

Section 17: This section states that no member participating or otherwise financially interested in the primary or secondary distribution of an issue may attempt to facilitate the distribution by inducing transactions in any security of the same issuer to take place on a national securities exchange. This rule is similar to rule 10b–2 under the Exchange Act.

Section 18: This section states that a member shall not effect a transaction by means of any fraudulent, deceptive, or manipulative device. This section is a broad fraud section under which any manipulative acts, practices or course of business which operate as a fraud upon any person would be actionable. This section is used frequently by the association but the study points out that many charges involving fraud might have been proved by the association had there been independent inquiry by association examiners beyond the member's books and records.[42]

Section 19: Subsection (a) of section 19 states that no member shall make improper use of a customer's securities or funds. This section is used by the association in disciplinary actions against a member or registered representative who has converted a customer's securities or funds and is also used in some cases where a member's financial condition indicates that it conducted a securities business with the public while, in fact, insolvent. The study notes that there are no procedures designed specifically to ascertain compliance with section 19(a).[43] Subsections (b) and (c) of section 19 contain two specific provisions intended to protect customers' securities. These deal with hypothecation and lending of securities and are patterned after and in some respects extend sections 8(c) and 8(d) and Commission rules 8c–1 and 15c–1 under the Securities Exchange Act of 1934. There have been few disciplinary proceedings involving these sections. The study, in considering the protection of customers' funds and securities in chapter III–D, questioned whether existing rules protect investors adequately and at the conclusion of this subchapter the study made five recommendations which would call for Commission rulemaking.[44]

Section 20: This section states that securities may not be sold to a customer under an arrangement providing for installment payments unless the provisions of regulation T are satisfied. In view of the fact that under such arrangement it is not possible to comply with regulation T, this section will be dropped from the rules in connection with the bylaw revisions.

Section 21: This section imposes upon a member compliance with all applicable bookkeeping rules and under this rule the association enforces the Securities and Exchange Commission bookkeeping and records rules as set forth in the association's manual.[45] Disciplinary matters involving these rules make up one of the largest categories of such actions.

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[41] Id. at 658.
[42] Id. at 659.
[43] Id. at 655.
[44] Supra note 4 at 387–416. Note especially pp. 400, 404, and 406.
[45] NASD manual, pp. I–9 to I–24.

Section 22: This section requires that a member make available to a regular customer information concerning the member's financial condition as disclosed in its most recent balance sheet prepared in accordance with existing laws and practice. There has been no disciplinary action based on this rule nor do we have information concerning requests made upon the members for such information.

Sections 23, 24, and 25: Section 23 states that no member shall sell a security to any person not engaged in the investment banking business or securities business which shows a concession, discount, or other allowances and section 24 states that selling concessions, discounts, and allowances shall not be given to anyone other than a broker/dealer engaged in the securities business but both sections 23 and 24 permit the sale of securities at a net price. These two sections are basically part of a framework more specifically spelled out in section 25 which provides the economic incentive for membership in the association. Under section 25 no member may deal with a nonmember broker/dealer except on the same terms and at the same prices as such member would accord to the general public. No member could join in a distribution of securities with a nonmember broker/dealer and, as pointed out in the study report, this section was the inducement to join the association and understood as such at the time of the adoption of the Maloney Act.[46]

Section 26: This section applies to the activities of members who engage in the sale of open-end management investment company shares. Under subsection (c) of this section no member may purchase shares from an investment company underwriter at a discount from the public offering price unless the underwriter is also a member and there is a sales agreement in effect between the dealer and underwriter. Subsection (e) of this section provides for the calculation of the public offering price with most underwriters calculating the price twice a day. Subsection (f) prohibits a member from withholding the placement of customers' orders so as to profit by such withholding and prohibits the purchase of shares other than for investment except to cover purchase orders. Subsection (h) covers redemption and (i) sales agreement provisions.

Chapter XI of the study report discusses various activities of the association relating to investment company matters. The Investment Company Act, the study notes, contains a specific provision concerning selling literature and notes that in 1950, in cooperation with the Commission, the association agreed to administer the Commission's statement of policy on advertising and sales literature to be used in the sale of mutual funds. The study notes that the Commission, for the most part, relies on the association to enforce compliance with this statement by association members.[47]

In discussing the association's activities in the area of mutual funds, the study states:

"c. NASD controls:

"Under the existing scheme of Federal regulation and industry self-regulation the NASD is the only self-regulatory body with a significant role in the control of practices employed in the sale of mutual fund shares and contractual plans. The national securities exchanges have not, with minor exceptions, attempted specifically to regulate their members' activities in this area. The membership of the NASD, however, includes almost all of the broker-dealers registered with the Commission which are engaged in the sale of mutual funds, with the conspicuous exception of certain large totally integrated mutual fund retail organizations which lack any economic incentive to become members." [48]

The study next reviews association rules, disciplinary actions and administration, detection, and enforcement by the association in the area of mutual funds.[49] The study notes that the rules of fair practice of the association discussed in detail in chapter III which cover, among other practices, fraudulent selling, "churning" or excessive trading, suitability and require that members supervise their salesmen apply to members in the sale of mutual fund shares and plans. In addition to these rules, article III, section 26 of the rules of fair practice deals with mutual fund discounts, unfair sales charges or commissions and minimum offering prices to be charged by underwriters and dealers. The association has, the study report states, also established other policies and interpretations to govern the preparation and use of mutual fund sales literature and

[46] Supra note 13 at 605.
[47] Id. at 161.
[48] Id. at 162.
[49] Id. at 163–168.

advertising in accordance with the statement of policy as well as certain ethical requirements relating to mutual fund selling practices of underwriters and dealers. In this latter category the study gives as an example the association's policy against "selling dividends" to discourage the practice of representing to investors that they gain an advantage by purchasing mutual fund shares shortly before a dividend date, when, in fact, no such advantage accrues.

In association disciplinary actions relating to mutual fund shares the study notes that four types of problems occur most frequently:

1. Violations of the statement of policy.
2. "Selling dividends."
3. Recommendations to switch funds.
4. Failure adequately to supervise salesmen.

The study notes that the investment companies committee of the association and its staff exercise surveillance over the association's enforcement of the Commission's statement of policy and that in 1961 over 10,000 pieces of literature prepared by dealers or underwriters who are members of the association were filed with the investment companies department and that 4,700 of these pieces required comment by that department. The study discusses the method of detection by the association of violations which principally is through the association's regular inspection program and that high pressure selling techniques are not susceptible of detection under normal circumstances by regular inspection. The study states:

"However effective the NASD may be in detecting improper mutual fund selling practices the penalties which it imposes are rarely severe." [50]

Part B of this chapter deals with special problems involved in contractual plans and evaluation of performance between these and voluntary plans. In the summary section of this chapter the study states:

"The Commission looks largely to the NASD for enforcement of the statement of policy, and the NASD has brought a number of disciplinary actions relating to its violation, as well as for charges of switching funds and 'selling dividends.' For the NASD too, however, the home sale of funds makes detection of high pressure sales a difficult problem." [51]

The Special Study has three recommendations at the end of part B.[52]

The first recommendation is that the industry representatives and the association in consultation with the Commission should jointly undertake a program designed to eliminate undesirable selling practices through the adoption of interpretations of the rules of fair practice. It would be desirable, the study states, for the association to increase its activities in surveillance of selling practices outside of the area of advertising and sales literature. Reference is made to chapter II as to other recommendations which are allied to those set forth here.

Chairman Cary, in his transmittal letter dated August 8, 1963, stated that the Commission was in agreement with this recommendation and, as has been indicated above in this statement, the association has a special committee of the board looking into selling practices, generally. When this committee meets with the staff of the Commission it will discuss the many aspects of this recommendation, including the item of supervisory controls.

Section 27: Subsection (a) of this section requires that members supervise transactions and correspondence and that they evidence approval of transactions in writing on the original memorandum or other record of the transaction, such evidence of approval to be made by either a partner, executive, or branch manager of the member. Subsection (c) of this section also puts the burden on the member to exercise care that a person employed as a registered representative be a person qualified and of such character and repute, to engage in the functions of a registered representative.

The study commented on this subsection (a) by noting that there was no systematic examination procedure for reviewing a member's policies and practices for supervising selling activities of employees.[53]

Section 28: This section together with an interpretation of it adopted by the board and set forth in the association's manual [54] states that when a member has

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[50] Id. at 167.
[51] Id. at 208.
[52] Id. at 212.
[53] Id. at 657.
[54] NASD manual, p. G–21.

a transaction with a customer known to be a partner, officer, registered representative, or employee he may execute the transaction only after he has exercised reasonable diligence to determine that the transaction will not adversely affect the interests of the member with whom the customer is associated. The executing member must notify his customer's employer that he purposes to open an account for this customer and is obligated to comply with instructions from the customer's firm as to copies of confirmations, monthly statements, depending upon the instructions received. This section is designed principally to prevent an officer or employee of one member who might seek to liquidate through another member securities not owned by the seller.

This concludes the discussion of the 28 sections of article III of the rules of fair practice which are considered the substantive, ethical rules of the association. Article IV of the rules of fair practices sets forth certain requirements and procedures as to complaints; article V sets forth the penalties for violations of the association's rules and article VI relates to the requirement that the association keep a current list of the membership and furnish this list on a current basis to all members.

In the interests of brevity, not every comment of the study group on association rules or activities has been repeated here and obviously the final authority on the study group's views and recommendations is the text of the study report. As stated herein, we have limited this reply to a discussion of specific rules and bylaw requirements relating to the protection of investors.

In the concluding section of chapter XII G.[55] the study states that the association has grown from an experiment in self-regulation to its present status as an established part of the regulatory scheme exerting substantial influence; that while the report is on occasion critical of the association's performance, the association has important accomplishments to its credit and its history evidences a clear desire to expand the role of self-regulation and to make self-regulation work. The study states the association is at a crossroads as its capacity to do its present job is strained and the study has suggested expansion of the scope of its affairs as well as strengthening of its performance.

At the conclusion of the chapter the study made nine specific conclusions and recommendations, with all of which the Commission agreed and, as pointed out earlier in this reply, all of which are now under study by a special committee of the Board of Governors.

CONCLUSION

In this reply to the House, we have endeavored to present a brief description of our rules, the comments of the study group as to each of them where comments were made, the comments of the Commission on any recommendations of the study group which involved changes in these rules, and, lastly, the board's comments on any suggested changes. We believe that the study reviewed extensively the operations of the association, commented specifically on the adequacy of the association's rules, enforcement of them and the study made specific recommendations for changes in, additions to and clarification of association rules as well as suggestions for strengthening enforcement.

Generally, the study found the framework of the rules broad enough to cover the areas where most of the abuses in the sales of securities occurred,[56] and that demonstrated strengths of the association outweighed its inadequacies [57] and that the study discussion of the latter "is not intended to overshadow or disparage the record of accomplishment but to point to an even stronger future role." [58]

Not every finding in the report would necessarily have been made by the association nor does the board believe every recommendation made should be adopted. But the board views the report as constructive criticism and will implement the report where the suggestions will promote better business ethics. The board is undertaking these studies now and has been and will be consulting with the Commission and its staff on the matters discussed in this reply to the chairman of the Committee on Interstate and Foreign Commerce.

Mr. STAGGERS. The reply represents an excellent job by setting down the Special Study Group's comments and the Commission position on the rules of practice, as well as your own comments thereon, and what you are doing in connection with each.

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[55] Supra note 13 at 673–679.
[56] Supra note 4 at 308–313; supra note 13 at 163–168.
[57] Supra note 13 at 504.
[58] Id. at 679.

I highly commend you for this reply, which will be of great assistance to us, and I should think it would prove equally valuable to each one of your members.

Mr. Van Deerlin, do you have any questions?

Mr. VAN DEERLIN. I will pass, Mr. Chairman.

Mr. STAGGERS. Mr. Glenn?

Mr. GLENN. If we pass this legislation and it is enacted into law, what will be your comparable position with the other exchanges? In other words, situations like floor trading on the New York and American Stock Exchange?

Mr. LEMKAU. I don't believe I quite follow you. In an over-the-counter market, would we be centralized in an auction area?

Mr. GLENN. Yes, sir.

Mr. LEMKAU. No; we would not be in a centralized area. The over-the-counter market involves broker-dealers spread throughout the United States, and they commune by telephone. Their business is not funneled into any one place. There are different broker-dealers who are primary market makers in different securities which are traded over the counter.

There is no one central place where an auction market can obtain.

Mr. GLENN. How do you keep advised of these dealings?

Mr. LEMKAU. Specifically, what type of advice, Mr. Glenn?

Mr. GLENN. Whether it is a trade between broker-dealers. Is it a report made to the National Association of Security Dealers?

Mr. LEMKAU. No, sir; there is no reporting made of trades in the over-the-counter market. That is where it differs from the auction market where all trades are in one place. Securities might be traded in Seattle at the same time that a trade is going on in Maine in the same security. But it is handled by a different broker-dealer and the sale to a different customer.

Mr. GLENN. How do they get into the newspapers and the financial periodicals which report these deals?

Mr. LEMKAU. We have a quotations committee which collects some 1,500 quotations from several sources in New York and we have local quotation committees throughout our 13 districts which collect quotations from dealers twice daily, which are adjusted to reflect a retail range and submitted to the papers.

(See p. 645 for additional information to Mr. Lemkau's response.)

Mr. GLENN. These are through your branch offices?

Mr. LEMKAU. District committee offices; yes, sir.

Mr. GLENN. They are in turn then reported to the main office, presumably in New York?

Mr. LEMKAU. Mr. Glenn, I might call on Mr. John Hodges, who is a member of our staff in charge of quotations, to answer this question.

Mr. HODGES. The quotations in cities throughout the country are compiled by the local NASD Quotations Committee and then submitted directly to the newspaper. The local lists would include securities which are locally active. The national list is compiled in New York and is furnished to the Wall Street Journal, The New York Times, and to the wire services.

Mr. GLENN. Aren't all these reports from your district offices correlated by one overall office and brought together so that there can be a proper daily compilation of what is going on throughout the Nation?

Mr. HODGES. All quotations? No. We are in the process now of expanding our staff to supplement the extent of supervision being exercised by the national office over the activities of local quotations committees.

Mr. GLENN. This is now in process?

Mr. HODGES. Yes.

Mr. STAGGERS. I would like to interrupt for a minute to ask this: How do you know in the 13 districts where the stock is selling a dollar below or above in that district? If we want to buy it in Washington, it might be a dollar higher someplace.

Mr. LEMKAU. I wonder if I might call on Mr. Haack.

Mr. HAACK. I am sure if there was a difference of a dollar or two between Washington and Chicago, somebody would be alert in Washington to equalize the market in the Chicago area.

Mr. STAGGERS. How would this be done?

Mr. HAACK. We have our facilities for disseminating wholesale dealer quotations. If there were a disparity in the market, for example, if the stock were available at 12 in Washington and somebody recognized a disparity in the market in Chicago and was willing to pay 14, he would soon find that out. That is the verdict of the marketplace.

Mr. STAGGERS. How is the public going to tell that? That is what I am trying to get at. Say, for instance, stock in a certain area has inside information given on it and it is discredited and it sells off. Somebody is buying it at a high price at the same time.

Mr. HAACK. Due to the communications that exist in the business, the alertness of dealers who are making markets, these disparities as a practical matter do not exist.

Mr. STAGGERS. What I am trying to find out is, Why is it they don't exist. If you don't have a direct communication someplace to get this information to them, what is your communication with them?

Mr. HAACK. The primary market makers, the professional traders, have a vast network of communications, teletypes, direct telephones, long-distance phones, correspondence in different areas. Their information is very current.

Mr. STAGGERS. If there is no reason for a man to inquire if someone wants to buy stock here and puts in an order for it, and it has been going along smoothly and something has happened in Chicago or in San Francisco, why should this man go someplace to inquire? Why should he be watching the ticker tapes or anything else? This doesn't come over a ticker tape.

Mr. HAACK. There are in the trade certain dealers who have become known as specialists in certain types of primary markets, either by local, historical interest in a security, a banking relationship with that company, or, if you please, they might be attracted merely by the trading volume that exists in that security. They are right up to the minute.

Mr. STAGGERS. That is what I am trying to find out. How are they going to get up to the minute? There are many stocks traded over the counter. If there are 13 districts and there is no direct accounting and centralization of these quotations and bids and asks, I don't see how it can be done. Perhaps it takes minutes for the stock to go up or down. If it is on the New York Stock Exchange, you know it.

How do you keep up with the over-the-counter is what I am trying to determine. Maybe I am back in one of the small communities that doesn't get these direct connections to which you are referring.

Mr. HAACK. I assure you that each dealer, first of all, if he is acting as a principal—buying and selling for his own account—and if he is putting his money on the line and taking a risk position by being either long or short, he is going to keep very currently appraised of the market, so that should take care of the dealer's alertness to changing conditions.

So far as the individual is concerned, I think that he can rely on the good faith and integrity of the dealer who is serving his account to execute that market at the best possible price at any given time. He will do this because of the wealth of communications and facilities that are available.

Mr. STAGGERS. Then the broker-dealer has so much of a certain stock to sell and somebody calls and wants it, maybe the quotation—he wants to sell it at a profit.

Mr. HAACK. He sure does.

Mr. STAGGERS. Perhaps something happens along the line and he sells the stock and the person who buys it is the one who is the victim.

Mr. HAACK. On the basis of my experience, I would say that every dealer or salesman who sells the stock does so at a price very closely related to the market.

Mr. STAGGERS. These are certainly transactions based upon the integrity of the human being.

Mr. HAACK. That is true.

Mr. STAGGERS. I will tell you when that involves a great amount of money, that is certainly putting much faith in many human beings. That great bulk of stocks which are being traded on this market might mean that we should go into this.

Mr. HAACK. Sir, there is one other thing that we might inject into this point. We do have our examination procedures of broker-dealer historical dealings. We do have facilities for checking the execution versus the market that existed at the time.

Mr. STAGGERS. Could I interject right here that when the hot issues were on in Washington, coming on the market at 7, and before they closed in the afternoon they were 17—I could name one issue—that relied on the broker.

Mr. HAACK. It relied on the demand for that stock at that time.

Mr. STAGGERS. Yet as soon as a little bit of information got out on the stock, it went way below. That is only one. I can name dozens. I can name several of the hot issues that came on the market in Washington and many people lost much money because, you say, they had faith in their dealer-brokers. A lot of those brokers came on the market and are gone by now.

Mr. HAACK. This ties to a certain extent into the qualifications and standard of competency that many of us are seeking at the moment.

Mr. STAGGERS. I understand. I do believe that other proposals will be brought forth in the legislation.

I am sorry, Mr. Glenn.

Mr. GLENN. Why can't over-the-counter securities be handled on the regular stock exchanges or an exchange set up by the NASD?

Mr. LEMKAU. I believe, sir, that there are some 13,000 or 15,000 issues of companies that are not listed. We have on the New York Stock Exchange 1,300 issues listed.

Mr. GLENN. This legislation is going to cause some more to be listed. It will be compulsory.

Mr. LEMKAU. Not listed. The legislation asks for information to be filed with the Securities and Exchange Commmission; but does not call for listing of these securities.

Mr. GLENN. Doesn't this legislation call for the registering of all companies with certain qualifying factors in the NASD?

Mr. LEMKAU. No. It calls for the registering of information by the companies, the filing of annual reports, interim reports, proxy material, with the Securities and Exchange Commission in a form comparable to that which is now required by listed companies, by companies whose securities are listed on an exchange.

This would apply with the million-dollar-asset test and the 750-shareholder test to some 3,100 companies, I believe, of whom some 1,100, perhaps, now do file such information.

Mr. GLENN. It seems to me that this legislation—we have been hearing from Mr. Cary—says that it will be compulsory for all dealers to become members of the National Association of Security Dealers; is that right?

Mr. LEMKAU. The legislation would require all broker-dealers to become members of a self-regulatory association.

Mr. GLENN. There is only one now, is there not?

Mr. LEMKAU. There is only one at the present time; yes. We do not know whether the broker-dealers who are not members of our association would join our association or establish one of their own. We believe that from an economic standpoint, it might be that they would wish to join ours in that we are in being and they would not have to establish one.

Mr. GLENN. Would you have any objection to the formation of an exchange by the NASD?

Mr. LEMKAU. I do not see that the NASD, or the over-the-counter business, lends itself to an exchange operation. We have the New York Exchange, we have the American Exchange, we have several regional exchanges, and yet the number of companies in this country which are too small to qualify for those exchanges just do not have sufficient investor interest in their stocks to warrant their being listed.

Mr. GLENN. Then why is it reported in the newspaper as the over-the-counter market if there is no interest in it?

Mr. LEMKAU. That relates to some 1,500 issues of companies which are of sufficient size.

Mr. GLENN. Why can't they be on an exchange of their own?

Mr. LEMKAU. I might call on Mr. Haack to try to explain the difference between an auction market and the over-the-counter market, which is a negotiated-type market, in contrast to what you have on the exchanges.

Mr. HAACK. The basic difference is that an exchange provides a centralized facility whereby bids or offers on an auction basis can be correlated and centralized. The issues that trade there meet certain proscribed standards. But the basic concept is that it is an auction market. That is not necessarily the case over the counter. That is a

negotiated matter between the dealer in Washington and the dealer in Boston, one expressing an interest in which he would like to buy stock and the other expressing a price at which he would sell stock.

Many of these securities that are traded over the counter meet listed qualifications, but for reasons best known to the management of these companies, they prefer not to be listed. Possibly there is not sufficient activity amongst dealers and retailers to warrant it being listed. Listing a security per se does not impart to it liquidity or marketability. That depends on supply and demand.

The stocks that you see quoted daily in the newspaper, some 1,500, are those that have met our standards so far as geographical distribution, stockholders—the number of stockholders—and things of that sort. There are many other companies in which the interest is so limited that to quote them would be superfluous. But the entire operation does not adapt itself to a centralized trading area.

Mr. GLENN. Thank you very much.

That is all, Mr. Chairman.

Mr. STAGGERS. Pursuing that just one moment, when one buys over-the-counter stock, it is found listed in the paper quotations at 22½, and that is asked. The bid is 21. Invariably when one buys it is necessary to pay the higher price; isn't that right?

Mr. HAACK. Close to it.

Mr. STAGGERS. Invariably if you want to sell, you get the lower price.

Mr. HAACK. Close to it.

Mr. STAGGERS. Who gets the difference in between?

Mr. HAACK. In the securities business, just as in many other businesses, there is a wholesale and a retail market. There are these primary market makers who at the risk of their capital do stand willing and able to buy this stock perhaps at 21, and they will offer stock at 21¾ to other dealers. Unfortunately, at least in my experience, you don't always buy things at the bid, and you don't always sell things at the offering. Ideally, you would, but it doesn't come out that way practically. But there is this wholesaler's profit which is compensation for his having assumed the risk.

Mr. STAGGERS. Then doesn't the investor have to pay a commission also?

Mr. HAACK. I am coming to that. A retailer who does not make a market or who is not in position will buy from one of the wholesalers and he will sell to his customer at a higher price and that difference represents his retail profit as contrasted to the wholesaler's profit.

Mr. STAGGERS. That is the big difference. The difference in the actual price the person can get on the market, bid and ask. That is the big difference between the over-the-counter and exchanges; is it not?

Mr. HAACK. I would say that is a fair statement.

Mr. STAGGERS. In the exchanges, they are immediately flashed to the central office at bid and ask and you buy at that price. Over the counter you invariably buy at the higher ask price or close to it, and if you want to sell that same day you probably will sell at that low price, which is the bid price.

Mr. HAACK. With one strong reservation: that the price that you see on the New York Stock Exchange is the result of a bid and an ask.

Mr. STAGGERS. That is right. I know that.

Mr. HAACK. There is the result of a bid and the ask in the over-the-counter market.

Mr. STAGGERS. There is always the spread. I am trying to say that the man who buys or sells, sells at what the bid price is. However, if he buys, he buys at the ask price, which is usually 1½ to 2 different. I have noticed in recent months that on most of the exchanges the bids and asks seemed to have closed up a little bit.

Is that something that the industry has done or is this a natural gravitation toward closeness?

Mr. HAACK. There is one other important difference. All of the transactions that you see on the New York Stock Exchange are handled in an agency capacity; whereas, the over-the-counter stock you mentioned may be handled in an agency capacity or it may be handled on a principal basis.

Mr. STAGGERS. I understand. I was just trying to get the difference and have you explain it a little.

Mr. Lemkau, as I understand it, the bill before us proposes to invoke a new disciplinary policy, and that is that the Commission may move directly against an employee or individual; whereas, hitherto the firm itself was held accountable for the actions of its members or employees.

I can appreciate why some firms would wish not to be liable for the actions of some of their employees, but I wish you would explain to me why your association, with its high standards of commercial honor and business conduct wishes now to relieve its member firms from complete accountability and liability for the actions of its employees.

Mr. LEMKAU. Mr. Chairman, this provision will permit us to act more quickly where a member firm has found one of its employees guilty of misconduct and reports it to us—they want to fire him. Perhaps the man has committed fraud and they, the member firm, know it. They report it to us.

Under present procedures, we must proceed both against the firm and against the individual. It is to obviate this for that specific type of crime, shall we say, or felony, that we wish not to have to name the firm and then dismiss against them before we find against the individual.

Mr. STAGGERS. You are not trying, then, to evade the responsibility of bringing charges against a firm if you found that they have been condoning conduct of their salesmen.

Mr. LEMKAU. Absolutely not. One of the responsibilities our bylaws provide for is supervision by firms of people employed by them. It is only a technicality, really, where the supervision has been or should have prevented the misdemeanor or the crime that we wish to proceed directly against the individual.

For instance, there have been cases where money has been stolen from a firm. It seems ridiculous to us to have to name the firm as well as the man who stole the money from them when we make a proceeding. This shortens our procedures and we can act more quickly against the individual.

Mr. STAGGERS. In relation to that, one of the proposals of the bill is to give you certain powers over your membership by reason of your members' misconduct in activities involving the rules of the stock exchange. I wish you would comment on the need for this rule. In doing so, bear in mind that in the testimony of House Joint Resolution 438 2 years ago, the president of the New York Stock Exchange testified that any member of the New York Stock Exchange is responsible

to the exchange for the performance of just and equitable principles of trade in any line of business in which he is engaged. Mr. William Claffin, then chairman of your board of governors, testified somewhat to the same effect as to your association in connection with the first section of article III of your rules of fair practice, which states:

A member in the conduct of his business shall observe high standards of commercial honor and just and equitable principles of trade.

Have you not taken action against members of your association who have violated exchange rules?

Mr. WHITE. Mr. Chairman, I think I recall that testimony of Mr. Claffin. As it relates to this section of the bill that is before us, we found in carrying out the requirements of our bylaws, which give us the power to summarily suspend a member if they are found in difficulty by some other organization—for example, the exchange—we have the right to summarily suspend them if their conduct on the exchange was inconsistent with just and equitable principles of trade.

If the exhcange made a finding that did not include that phraseology, then we could not invoke the automatic part of our bylaws. So that where an exchange took action against an individual or a member and didn't make a finding, we would then have to go back and start our own proceeding in order to establish a bar or impose a suspension or another penalty.

This bill would allow the association to work out a system with the New York Stock Exchange where, if they imposed a penalty of suspension against one of their members, that we could make the suspension automatic for our purposes.

To go back to your last specific question, we don't enforce exchange rules unless it happens to be a rule that we also have.

Mr. STAGGERS. Mr. Cary testified yesterday that this amendment was needed to resolve a problem existing primarily between NASD and the New York Stock Exchange with regard to the collateral effects of the latter's disciplinary proceedings.

Is the problem such that it requires amendment of your rules, or should it be an amendment of the exchange rules, in your opinions?

Mr. WHITE. That would be a matter of opinion, but I believe this bill would take care of the problem. What has happened in the past is that the exchange may take action under one of its rules, and not make the finding that the conduct was inconsistent with just and equitable principles of trade, which then prevented us from automatically invoking our bylaws which would, in turn, suspend the member and necessitated our starting our own proceedings to establish the disqualification.

I would think that the bill takes care of the problem. The problem has not been too great. Actually, I don't think it would call for any amendment of our bylaws.

Mr. STAGGERS. You think the bill is adequate.

Mr. Lemkau, in your reply to the October 16 request of the committee, on page 9, you state that you have given much thought to the Special Study recommendation of minimum net capital requirement. You say you have considered the suggested minimums of $5,000 and $2,500 and you also say, a review of your membership shows that with the requirement of $5,000, 25 percent of your membership would not qualify, although many might raise additional capital.

I just wondered if you would care to comment on that. I appreciate your association might adopt rules as to a net minimum capital, but I do not quite understand the reference to the Commission's adoption of rules.

Was this not one of the subjects which in 1959 the Commission sought by proposed amendment including section 8 to secure authority to deal with bylaws and regulations?

Mr. LEMKAU. That is correct, sir. It is the feeling of the board of the NASD that anyone who is handling other people's money should have at least $5,000 of his own money in the business.

Mr. STAGGERS. Yesterday Mr. Loomis made a statement, and I didn't quite understand it, that the Commission already has the power to issue such a rule. I did not think that the 1959 bill became law, although I am aware that certain power lodges under section 15(c)(3). Do you have any comment on that power under the section?

Mr. LEMKAU. Only that, as I understand it, the NASD, the self-regulating agency, did not have the power, and does not have the power unless this legislation is passed. When the bill was introduced by the Securities and Exchange Commission, it seemed to imply that the judgment as to what terms should be required for minimum capital would be handed to the self-regulatory agency.

Mr. STAGGERS. What I meant is, Does the Commission have the authority to do this?

Mr. LEMKAU. So I have more recently learned. The Commission does have the authority, or at least the Commission has so stated to me. Let me word it that way.

Mr. STAGGERS. Yesterday Chairman Cary was asked whether the Special Study had developed that manipulations in the market today were as rampant as Mr. Cary had stated they were 2½ years ago when we were considering House Joint Resolution 428 authorizing this study. If I understood him correctly, and I think I did from other statements made here today, he said it was as rampant today as it was then.

Mr. LEMKAU. I didn't quite hear the last of that, Mr. Chairman.

Mr. STAGGERS. That the manipulation was as rampant today as it was then, 2½ years ago.

Mr. LEMKAU. We have not found it in our inspection system.

Mr. STAGGERS. He made the statement that there were more referrals to the Justice Department today than there were then.

Mr. LEMKAU. In our own examinations, we have filed more complaints recently, but it may be because of a step-up in the examination program.

Mr. STAGGERS. What would be the cause of that—because there was not an inspection program adequate at that time?

Mr. LEMKAU. No. We have increased the number of examiners. We are examining more people. Some of these cases actually for which complaints were filed in 1962 and so far in 1963 were cases where the errors found by our inspectors had occurred during the earlier period. It might have been 1960 or 1961. When we uncover these, then we bring actions.

Complaints filed, for instance, in the year 1962, were 452. During that same year we heard and completed 483 complaints, which meant that there had been a carryover from the prior year. At the end of the year we had 348 complaints pending.

The association in connection with that, with the findings in those complaints, expelled some 50 members, revoked the registration of some 71 representatives, and we suspended 15 member firms and 32 registered representatives. We fined some 317 members and 64 registered representatives. We censured some 331 members and 90 registered representatives.

Now, for the first 10 months of this year, we had cases which involved the expulsion of 59 members, the revocation of 115 registered representatives. We suspended 18 members and 39 registered representatives. We find 203 members and 138 registered representatives. We censured some 243 members and 166 registered representatives.

However, that activity covered not only the present 10 months, but related to acts that had occurred in the prior year or two, so I do not think from that activity it should be inferred that manipulation in the market is as rampant today, if there was manipulation in the market 2 years ago.

Mr. STAGGERS. Mr. Lemkau, it certainly does highlight the fact that something is going on that needs to be corrected.

Mr. LEMKAU. That is correct.

Mr. STAGGERS. Certainly if the Study Group has not done any other single thing, it has done some good in that respect. I think perhaps the investor today should investigate his broker a little more to see with whom he is dealing. I believe they brought that to light. I think if it could be given the light of publicity, it might be quite helpful across the Nation to many people who just blindly invested their money. I don't know why it has been held down and has not been given publicity. I can understand, too, many persons do not want publicity on their activities.

I believe it would be helpful to the investors of the Nation if they knew that these corrections had beeen taking place and the amount of them, and perhaps clearing up some irregularities.

In regard to that, when your association appeared before this subcommittee 2 years ago on H.R. 2480, a bill to amend the Securities and Exchange Act of 1934, you opposed several of the provisions of that bill solely on the ground that statutory standards should be written into the law itself to incorporate what the Commission said should be done rather than leave it solely to the Commission to issue rules and regulations to carry out what the Commission said it intended to do. When two of the sections were so amended, you withdrew your opposition.

I wonder whether you can tell me why your association takes a different view now of the drafting of a statute than it did then?

Mr. WHITE. In the 1959 bill, there were many provisions—I will take a guess and say 28 provisions in that legislation. The first draft of the bill given the association contained requests for broadening of powers with limited explanation as to the reasons the Commission felt itwas necessary to have these powers.

The initial reaction of the Board of Governors was that there was not sufficient explanation to justify the need. Subsequent to that, the Commission circulated technical statments and statements explaining at great length why they needed these additional powers to accomplish the ends for which they were organized.

The Board of Governors then withdrew a vast number of its objections because the need for this regulatory control by the Commission was explained. In this particular bill, these bills were circulated to the industry groups and legal associations and these explanations were given and in most instances the Board was satisfied with the explanations and in the vast number of the areas in this bill that do grant broad powers, the powers will at least be given to the self-regulatory agencies.

For example, in many areas they have suggested that the association continue their efforts.

Mr. STAGGERS. With regard to that, in hastily going through the bill, it shows that about 19 times in the 12 sections the bill gives this power to the Commission to do just what we were talking about there. It is empowered to issue rules and regulations, and there are many more times than that where the Commission is empowered to issue orders.

Do you feel that any of these matters can be spelled out in clear, statutory language and standards set forth in the law itself?

Mr. WHITE. In the one instance where they have made an exception for insider trading, where there is a sponsor market maker, they intend to draft rules in connection with that. In connection with the drafting of that rule, they will put out a notice to the industry and to the public and provide the association and other interested groups with the opportunity to come in at a hearing on that rule and oppose certain sections of it or make suggestions or say why it would be unworkable.

In the areas where I can think offhand in this bill where they have rulemaking powers, I think we have all the safeguards that we need in discussing the rules before they are promulgated and interposing any objections we might have to them.

Mr. STAGGERS. Then you don't think they should be put into statutory language or into the bill itself?

Mr. LEMKAU. Not in the bill that we are contemplating at this time, I believe, Mr. Chairman.

Mr. STAGGERS. I feel, Mr. White, we should have a reply from your board of governors to this committee, because I think it is a matter that is important in the consideration of the bill itself.

Mr. LEMKAU. We would be happy to do that, sir.

(See p. 645 for response to the above request.)

Mr. STAGGERS. Thank you. I understand from your statement that your association now supports the provisions of section 6(a) of the bill, which would eliminate the Commission's need to show that the mails or instrumentalities of interstate commerce had been used when the Commission moved against violations of statutes or rules or regulations.

I believe owing to your opposition, this was one of the items that was dropped from the Commission's legislative program in 1956 and 1957, the program prior to the 1959 program, which I was discussing briefly yesterday.

Would you explain more fully why you now support this complete Federal preemption of the securities field? I understand you have some feelings that it already is so greatly taken up that the whole amount would not be exempted much more if this were in it. Is this true or what is your reaction?

Mr. LEMKAU. Our reaction really is that people who are in the securities business handling other people's money should be qualified. We have examinations, and although we have made them more difficult, they are really not terribly difficult examinations for a person experienced in the business, to keep out people who are not familiar with the securities business.

It seems to us, I believe we are getting into the area where we are talking about removing the exemption of an intrastate dealer. It is our feeling that there is no harm that can be done by having men of the same caliber handle other people's money as does a member of the association.

Mr. STAGGERS. If this were granted, according to the bill, would it give the Commission power over all the transactions and activities of broker-dealers here in the District of Columbia?

Mr. WHITE. Yes; I believe it would, Mr. Chairman. Most of the people who do business in the District of Columbia, I think, have to do it on an interstate basis because they have offices in Virginia and Maryland. In any event, it would take into account everybody who was a broker-dealer in the District.

Mr. STAGGERS. That might be important to some of the people who live in Washington because of the actions of some of the small dealers in the past. In 1959, your association, through a letter from your counsel, Mr. White, indicated its support of the revised section 32 which would have provided stiff penalties for violations of the reporting requirements of the act. I know you here today are supporting the repeal of section 32(a), which provides for forfeiture of $100 a day for failure to file required information and reports.

Why have you changed your position now?

Mr. LEMKAU. We were merely going along with the Commission. I think they found it impossible to collect the levies or to make the levies and/or collect them.

Mr. WHITE. The Commission was urging a different approach some years ago, and the board reviewed that in connection with its review of the legislation and agreed to support the Commission. I don't think they singled that out as the most important feature of the bill as the association was concerned, because it is a matter primarily for the Commission.

As I understood Commissioner Woodside yesterday, he said that there had been a change in the viewpoint of the Commission between that Commission and this one. I think that the board, in connection with this section of the bill, merely is relying on the present Commission's approach to it.

Mr. STAGGERS. You are going along with the Commission?

Mr. WHITE. Yes.

Mr. STAGGERS. That was your attitude 2 years ago?

Mr. WHITE. As near as I remember it; yes, sir.

Mr. STAGGERS. What did the Special Study Group and the Commission have to say about the composition of your board of governors? Would you care to comment?

Mr. LEMKAU. The Study Group suggested that we review the matter in which we might have representation of all phases of the securities business represented on the board and suggested perhaps we might add one or two governors, not representing any one district, but rep-

resenting some phase of the business, so that we would have representation, for instance, of mutual funds on the board.

They also suggested that the executive director might be represented on the board, and have a vote.

All of this is under study by a committee of the present board, along with the other items covered in chapter XII relating to the association.

Mr. STAGGERS. You have done nothing about it?

Mr. LEMKAU. We have made no change so far.

Mr. STAGGERS. But you do have it under study?

Mr. LEMKAU. Yes, sir.

Mr. STAGGERS. Would you tell us just how affiliated or how independent your board is from the membership of the New York Stock Exchange?

Mr. LEMKAU. May I ask you to repeat that question, sir?

Mr. STAGGERS. All I was asking was about your board and how independent it was of the New York Stock Exchange.

Mr. LEMKAU. We are completely independent from the New York Stock Exchange, although, of course, many of the members of the board are members of firms which are members af the New York Stock Exchange.

But our actions in connection with the over-the-counter market are not tied in at all with those of the New York Stock Exchange. We do try to have liaison with them as to which organizations should carry out any disciplinary action, depending on whether a finding is made that an error was made by a firm in the New York Stock Exchange area or in the over-the-counter area.

Mr. STAGGERS. How many are on your board of governors?

Mr. LEMKAU. Twenty-one.

Mr. STAGGERS. How many of them, if you have the count, belong to the New York Stock Exchange through member firms? If you don't have it readily available, will you supply it for the record?

Mr. LEMKAU. We will be happy to supply it.

(See p. 645 for response to the above request.)

Mr. STAGGERS. On page 16 of your reply to the request of October 16, you start a discussion of some of the policy interpretations you have issued under the rule of fair practice requiring that in the conduct of his business a member shall observe high standards of commercial honor and just and equitable principles of trade.

On page 17, you refer to your markup policy, and what it has meant. In this connection, I recall the discussion we had before this subcommittee at the time we were considering House Joint Resolution 438 as to whether this markup policy applied to investment company securities.

Have you now so applied it?

Mr. LEMKAU. No.

Mr. STAGGERS. You have not.

As to the provisions of the 1934 act, as amended, to provide for registration of issuers whether or not their securities are listed, I am reading from line 14, page 6 of the bill:

> Every issuer which is engaged in interstate commerce or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentalities of interstate commerce shall—

Don't we have some new qualifications here? I believe there is much in the Securities Act that is based on the use of the mails or means

or instrumentalities of interstate commerce. What is this new test which is expressed in the alternative, not the conjunctive, of being engaged in interstate commerce or in a business affecting interstate commerce?

Is the Commission to make this finding? If so, what criteria would it use and what is the meaning of it?

I might say this did not appear in the original draft. Who added it, I would like to know? I wonder if you know?

Mr. WHITE. We did not add it. Rather than attempt to answer that by comparing the old language and the new one, and I probably should have it offhand, but I don't, could we submit that answer for the record?

Mr. STAGGERS. Yes, I would like to know. I really would. I know when it was presented to you, it didn't have it, and later it did have it.

(The information requested of the National Association of Securities Dealers, Inc., follows herewith:)

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Washington, D.C., December 4, 1963.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
U.S. House of Representatives, Washington, D.C.

DEAR CHAIRMAN HARRIS: During the hearings on H.R. 6789, Subcommittee Chairman Staggers directed a question to the association which could not be accurately answered at that moment. Chairman Staggers' question, which appears at page 457 of the transcript of the hearings held on November 21, 1963, inquires as to the number of members of the association's board of governors who are associated with firms which are members of the New York Stock Exchange.

Answer.—Our records indicate that 17 of the 21 current governors are associated with New York Stock Exchange firms.

In addition, at pages 458 and 459 of the transcript, Chairman Staggers questioned the association in respect to section 3(c) of the proposed bill (H.R. 6789, p. 6, lines 14 through 16). This section would add to section 12 of the Securities Exchange Act of 1934 a provision requiring the registration, with the Securities and Exchange Commission, of securities of certain issuers "* * * engaged in interstate commerce, *or in a business affecting interstate commerce* * * *" (italic supplied). Chairman Staggers inquired whether some new qualification had been added to the proposed bill by the phrase above italicized and asked if the Securities and Exchange Commission is to make the finding that an issuer is engaged in "a business affecting interstate commerce" and, generally inquired as to the meaning of the phrase. Chairman Staggers noted further that the questioned phrase was not contained in the original draft and asked who had added it. As the association was not then in a position to respond we requested an opportunity to submit an answer for the record.

Answer.—We have reviewed our records and note, as did Chairman Staggers that the additional phrase was not contained in the original undated draft legislative proposal prepared by the Securities and Exchange Commission and received from the Commission by the association late in April 1963. We further note that the questioned phrase was contained in the draft proposal of the Commission received by the association on or about May 24, 1963, in the same style as is contained in S. 1642. The association did not ask that the phrase be added.

Thus, it appears that the phrase was included in S. 1642 at the suggestion of the Securities and Exchange Commission. The association did not object to this phrase and did not address any comment to it during the Senate hearings since, in general, the association supports the broad aims of this as well as the other provisions of the bill.

Mr. Staggers also, at page 453 of the transcript, requested that the board of governors reply to the lack of statutory standards in the bill and the overall order and rulemaking power which would be granted the Commission by H.R. 6789.

Answer.—The board of governors believes that proper notice and opportunity to be heard, as required by certain provisions of the bill and by the Congress under the Administration Procedures Act, will be afforded interested parties in

connection with such powers, which do not appear to be significantly broader than those granted previously by the Congress to the Commission.

In response to a question from Mr. Glenn concerning records of securities transactions and quotations of securities prices at page 431 of the transcript, I replied that the association's quotations committee collect some 1,500 quotations daily which are then submitted to newspapers. I should like to supplement this answer for the record at page 431, by inserting "adjusted to reflect a retail range and" prior to the word "submitted." Quotations are bid and asked prices, subject to change, which before publication are adjusted by the quotations committees to reflect a retail range in which a customer could have expected to buy or sell a security at the time of the quotation. While the Report of the Special Study of the Securities Markets fully covers this area, it is my intention to clarify the point that the quotations referred to by me contain the adjustments noted.

Please advise me should you desire further supplementation, for the record or otherwise, respecting these matters. It is our understanding that Mr. Rockefeller will reply separately to the question addressed to him by Chairman Staggers at page 464.

Very truly yours,

HUDSON B. LEMKAU,
Acting Chairman, Board of Governors.

Mr. STAGGERS. In relationship to that I notice you have Mr. Rockefeller with you. I would like to ask him one or two questions, if I may. It is my understanding that you have been chairman of the industry advisory committee on this legislation, is this true?

Mr. ROCKEFELLER. Yes, sir. May I qualify that a little bit? When the Commission first proposed their original draft of legislation Chairman Cary wrote to several industry leaders requesting that certain groups be formed to study various phases and invited the comments of these groups on the proposed legislation. Because of the time involved or the time limitations involved, this group was made up of representatives of the New York, American, and Midwest Stock Exchanges, the NASD, the Investment Companies Committee and the Association of Stock Exchange firms and the IBA combined their efforts in one committee and sat down with the Commissioners to discuss various phases of the legislation. Our title for the committee was Liaison Committee, intimating a liaison between the industry regulatory bodies and trade associations.

Mr. STAGGERS. You were chairman of that advisory committee?

Mr. ROCKEFELLER. I sat in that position, yes, sir.

Mr. STAGGERS. I have a few questions I would like to ask you, if I may. In general my questions consist of two lines of inquiry. First, whether there is contained in the bill before us one single provision that was opposed by any segment of the industry in 1959?

Mr. ROCKEFELLER. We did not at that time make an analysis or compare this actual draft of the bill with the 1959 bill mainly for lack of time. As you may remember, the first issue of the study group was issued on April 3 and there was a time pressure in reviewing the draft legislation so it could reach Congress in time for possible enactment this year.

Mr. STAGGERS. There were 11 points set forth in that?

Mr. ROCKEFELLER. The 1959.

Mr. STAGGERS. Yes. The bill that passed the Senate and was reported by this committee but never enacted into law as it did not pass the House. Do you know the provisions of that?

Mr. ROCKEFELLER. I read them over. I can't recall them all right now.

Mr. STAGGERS. Do you know if there is any one single provision to which the industry objected that is involved in this bill today?

Mr. WHITE. I can't say but I know that one-half of the bill today relates to Frear-Fulbright kind of legislation and that was not in the 1959 package. Most of the specifics in the other half of this bill relate to ideas or conclusions that stem from the study report. So I don't think there is very much in this present legislation that was present in the 1959 proposal.

Mr. STAGGERS. In regard to that I would like to know—and this still is addressed to you, Mr. Rockefeller—whether in the bill before us there is contained any provision of the initial drafts of legislative proposals circulated by the Commission last April and May to which any of the industry advisory committee took exception?

Mr. ROCKEFELLER. I think there are in here now—I cannot give you an exact precise number because with the diverse group we had represented on this committee, which I think you will recognize, there were varying degrees of support or opposition for various phases of the draft legislation. For example, the NASD took violent exception to the original proposed shareholders tests of the 300 on companies on which they filed further information with the Commission. The eventual reading of the bill increased this original 300 shareholder tests to the 750–500 test with the addition of a further test of a million dollars of assets.

Mr. STAGGERS. If I might interrupt you, I ask this not as the NASD. I said the Advisory Committee, that they were opposed. Is there any single provision that is in the bill that you opposed at that time? That is, the original draft which was circulated to you and which was opposed by your Advisory Committee. Does this bill contain any single phase that you oppose?

Mr. ROCKEFELLER. I cannot think of any. Can you, Mr. White?

Mr. WHITE. At these Advisory Committee meetings before the Commission, Mr. Lemkau, for example, represented the association and there was no advisory liaison group general position. We were free to state the position of the association which in many cases differed from other organizations, or I will say in some cases. So one group, for example, the exchanges who have testified, were satisfied with the shareholder limits in the disclosure provisions of the bill, while other groups were asking for a higher number of shareholders before the bill would apply. So each organization, even though represented in this advisory group, spoke as the board had directed it in connection with the legislation.

Mr. ROCKEFELLER. That is right. I think your question is, is there anything in the current bill——

Mr. STAGGERS. That your advisory committee opposed. I am not asking the NASD. I am asking you as the chairman of the advisory committee.

Mr. ROCKEFELLER. I cannot think of any, no, sir.

Mr. STAGGERS. Then I would inquire into the nature of the changes made or items dropped by the Commission following their discussion with your committee. For example, what changes were made in the Frear-Fulbright provisions, that is, those provisions requiring universal registration.

Mr. ROCKEFELLER. Of all broker dealers?

Mr. STAGGERS. That is right.

Mr. ROCKEFELLER. The section 16(B) which would require the reporting of insider trading and recapture of short swing trading profits by broker dealers.

Mr. STAGGERS. Can you tell me of any other changes or deletions?

Mr. WHITE. We are now talking about——

Mr. STAGGERS. I am asking the Advisory Committee. Since he is with you today and I know he served in an official capacity as Chairman of the Advisory Committee. Could you supply them for the record, Mr. Rockefeller?

Mr. ROCKEFELLER. We will. I think probably the best answer to this would take a direct comparison and supply that for the record. On the entire bill or just the Frear-Fulbright part of the bill?

Mr. STAGGERS. To my last question, what other changes or additions were made?

Mr. ROCKEFELLER. To the entire bill.

(The documents referred to follow:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 12, 1963.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: This will acknowledge your letter of December 2, 1963, requesting a comparative print of the initial drafted bill as proposed by the Commission to the securities industry last spring, and the draft as submitted by the Commission for introduction to the Congress. We are preparing such a comparative print and will submit it to you as soon as possible.

As you suggest, we have reviewed the testimony of Mr. Avery Rockefeller, Chairman of our Industry Liaison Committee, before your subcommittee on November 21. In this connection we should point out that the Industry Liaison Committee was composed of representatives of various organizations in the securities industry, none of whom was in a position to commit the others to any position. Consequently, the Liaison Committee determined not to take any position as a committee with respect to any issue. We were advised of this in our initial meeting with this Committee on April 24, 1963, and further advised that individual organizations in the industry would determine their own positions, which might differ from that of other organizations.

As it turned out, there were occasional provisions on which one of the spokesmen took a different position. For example, two industry groups testified before your subcommittee that they supported H.R. 6789 but suggested a test of 1,000 stockholders in place of the test of 500 stockholders for application of the disclosure provisions as provided in our draft bill.

A provision authorizing the Commission to suspend trading in the over-the-counter market was contained in the 1959 bill and is also contained in H.R. 6789. In 1959, the National Association of Securities Dealers, Inc., in their statement to your subcommittee, questioned this grant of power. They, however, expressed no opposition to it in connection with H.R. 6789. I believe that this provision is the only one contained in both bills with respect to which the industry raised questions in 1959.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 27, 1963.

Re H.R. 6789, 88th Congress, 1st session.

Hon. HARLEY O. STAGGERS,
Member of Congress, Chairman, Subcommittee on Commerce and Finance, House of Representatives, Washington, D.C.

DEAR MR. STAGGERS: This is with further reference to your letter of December 2 requesting a comparative print of the initial draft of the bill as proposed to the Industry Liaison Committee in April and the bill as submitted to the Congress on June 3. You refer also to the request which you made to Mr. Avery

Rockefeller, Jr., on November 21 for a comparison between the initial draft of the bill and the bill as introduced.

A comparative print has now been completed and is in the process of final checking. We hope to have it in your hands next week. With respect to your request to Mr. Rockefeller for a comparison, he discussed this matter with us and requested our assistance, since he was not sure that information in his possession would enable him to respond fully and with complete accuracy to your questions. As a result of these discussions, we undertook to prepare such a comparison and I enclose copies herewith for your use. We have also supplied copies to Mr. Rockefeller, and we understand that he will be in touch with you and will give you any comments he may have with respect thereto.

Sincerely,

WILLIAM L. CARY, *Chairman.*

DOMINICK & DOMINICK,
New York, December 27, 1963.

Hon. HARLEY O. STAGGERS,
Chairman, Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House Office Building, Washington, D.C.

DEAR SIR: During the testimony of the National Association of Securities Dealers, Inc., at the hearings held by your subcommittee on H.R. 6789, November 21, 1963, you asked me certain questions with reference to the securities industry's Liaison Group.

By way of background, I might say that this group was formed in response to a letter of April 3, 1963, a copy of which is attached, from Chairman William L. Cary of the Securities and Exchange Committee to Messrs. Hudson B. Lemkau, Amyas Ames, and Keith Funston representing respectively the National Association of Securities Dealers, Inc., the Investment Bankers Association of America, and the New York Stock Exchange.

Also attached is their answer of April 11, 1963, to Chairman Cary's letter—establishing the Securities Industry Liaison Group. The role of the Liaison Group was defined in the April 11 letter as:

"The group will act solely in a coordinating capacity and take no votes. If a common industry point of view can be developed it will be so stated; if there is a divided opinion the division will be identified."

As Chairman of this Committee, my primary duty was the coordination of the various individuals representing the self-regulatory and industry groups listed in the reply to Chairman Cary.

The Liaison Group never acted in an advisory capacity, nor was it envisioned that the group would infringe upon the prerogative or obligation of any committee member to deal directly with the SEC or any other member. In our meetings with the Commissioners, the various aspects of the proposed legislation were discussed and reasons for it explored. Agreement with or opposition to any of the proposals in this legislation was indicated by the various members of this group as representatives of their respective organizations. After discussion, certain proposals were changed or eliminated or marked for further study as the result of the comments of all participating parties, including the SEC.

In view of the fact that the Securities and Exchange Commission was requested to submit, and has prepared a comparison of, the differences between H.R. 6789 as introduce dand the draft of this proposed legislation as submitted to the Industry Liaison Group on April 19, 1963, I am enclosing a copy of their memorandum. I have read the Commission's memorandum and I am in agreement that it presents and comments correctly on the differences between the draft and the bill to the best of my recollection.

Sincerely yours,

AVERY ROCKEFELLER, Jr.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., April 3, 1963.

Mr. HUDSON B. LEMKAU,
Acting Chairman of the Board,
National Association of Securities Dealers.
Mr. AMYAS AMES,
President, Investment Bankers Association of America.
Mr. G. KEITH FUNSTON,
President, New York Stock Exchange.

GENTLEMEN: As you are well aware, the Commission reported to the Congress today with respect to its Special Study of Securities Markets. The entire report of the study is not yet available but should be completed within 2 months.

The report will, of necessity, involve a legislative program as well as proposals for rule changes, on our part and on the part of the exchanges and the National Association of Securities Dealers. Conferences with the committee chairmen in both the House and the Senate lead us to the conclusion that our legislative proposals should be available as soon as possible after the report is filed in order to give the Congress adequate time for their consideration during this session.

The congressional resolution authorizing the study directs the Commission to submit its recommendations for legislation. We are preparing draft recommendations now, and shall ask you to review them as soon as they are ready. As a practical matter, a draft of legislation fully satisfactory in every detail to both the financial community and the Commission could not be agreed upon and submitted to the Congress within the rigid time limitations imposed upon us. At the same time, we not only welcome but encourage the views of the representatives of the securities business on any of our proposals. We clearly want to avoid any legislative proposal which is neither practical from a responsible business standpoint, nor sound from a policy standpoint. You may be assured that every suggestion of the industry will be carefully considered and, if any important disagreements cannot be resolved, we shall bring that fact to the attention of the Congress.

Under these circumstances, rather than waiting until our legislative proposals are fully detailed, we ask you as three leaders of the securities industry to take the major role in forming representative committees at the earliest possible time to consult with the Commission and the staff. Since the following subjects will be part of our legislative program, perhaps a committee might be selected jointly by you for each topic:

(1) Qualification for entry into the business; modification of the sanctions and registration sections dealing with broker-dealers and individuals; broadening the membership subject to self-regulation.

(2) Registration with the Commission of companies publishing quotations and presently not subject to either Federal or self-regulatory controls.

(3) Extension of sections 13, 14, and 16 of the Securities Exchange Act of 1934 to companies whose securities are traded in the over-the-counter market.

(4) Extension of the 40-day prospectus requirement in the case of new issues.

These subjects are more fully discussed in our letter of transmittal to Congress. There may be a few other areas of proposed legislation (particularly security credit) and we shall inform you as promptly as possible.

Obviously, now that our Special Study Report is published, many persons in the industry will properly desire to speak to us. However, with our immediate and continuing responsibility to implement the recommendations of the study (both through legislative proposals, rulemaking, and discussions with the self-regulatory institutions), we shall not have time to discuss each of the problems covered with all who are interested. The formation of representative committees appears to us a reasonable way of assuring that we shall have the benefit of the views of the industry. We would hope that the committees will be formed at the earliest possible time in order that they will be in position to comment on whatever proposals we then have available.

The securities industry has been most cooperative and helpful during the entire period of the Special Study of Securities Markets. We very much appreciate this cooperation and would hope and anticipate that we shall continue to work together in the same way.

Sincerely yours,

WILLIAM L. CARY, *Chairman.*

APRIL 11, 1963.

Hon. WILLIAM L. CARY,
Chairman of the Securities and Exchange Commission,
Washington, D.C.

DEAR CHAIRMAN CARY: We have your letter of April 3 and following suggestions made in that letter we outline below the organization plan for our securities industry liaison group.

The members of the securities industry liaison group will be:

For the over-the-counter markets, investment banking and other industry matters: Avery Rockefeller, Jr., chairman, NASD Study Group Legislation Committee; Wallace H. Fulton, executive director, NASD; Amyas Ames, president, IBA; Bayard Dominick, president, Association of Stock Exchange Firms.

For the stock exchange: G. Keith Funston, president, NYSE; Edwin D. Etherington, president, American Stock Exchange; James E. Day, president, Midwest Stock Exchange.

For the investment companies: Dorsey Richardson, president, Investment Company Institute.

The above-named officials or their directly appointed alternates will act as a liaison group to counsel with the responsible organizations and with the SEC in an endeavor to work out an approach to each of the several problems which will be acceptable to the securities industry as well as to the SEC.

The group will act solely in a coordinating capacity and take no votes. If a common industry point of view can be developed it will be so stated; if there is a divided opinion the division will be identified.

The existence of this committee in no way will infringe on the prerogative and obligation of each organization to deal directly with the Securities and Exchange Commission in any matter. Each organization must decide for itself its views on matters affecting it and present them officially to the Securities and Exchange Commission and to the Congress.

To the extent thought necessary or advisable, special study groups will be organized by the liaison group in any of the several problem areas.

Avery Rockefeller, Jr. will serve as chairman of those study groups concerned with NASD problems; Keith Funston as chairman of study groups concerned with stock exchange problems; Amyas Ames as chairman of study groups concerned with investment banking problems, and Dorsey Richardson as chairman of study groups concerned with investment company problems.

We appreciate very much the interest of the Commission in an orderly approach to these matters which so affect the public interest and we look forward to cooperating with you.

Sincerely yours,

HUDSON B. LEMKAU,
Vice Chairman of the Board,
National Association of Securities Dealers Inc.
G. KEITH FUNSTON,
President, New York Stock Exchange.
AMYAS AMES
President, Investment Bankers Association of America.

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION WITH RESPECT TO CHANGES IN H.R. 6789 BETWEEN ITS SUBMISSION TO THE INDUSTRY LIAISON COMMITTEE AND ITS INTRODUCTION IN CONGRESS

At the hearings on H.R. 6789 before a subcommittee of the House Committee on Interstate and Foreign Commerce on November 21, 1963, Chairman Staggers requested Mr. Avery Rockefeller, then appearing as a witness, to submit for the record a comparison between the bill as introduced and the draft which was submitted by the Commission to the industry liaison committee. Chairman Staggers later asked the Commission to provide a comparative print, which is also being submitted. Under the circumstances, the Commission deems it appropriate for it to provide the following information with respect to the matter.

On April 19, 1963, the Commission submitted a draft of its proposed legislative program to an industry liaison committee composed of representatives of the principal industry organizations, which subsequently testified on this legis-

lation, and their counsel. It should be noted that the draft submitted to the committee was based essentially upon the recommendations of the Special Study. The Commission, although it had accepted the legislative recommendations of the study which were embodied in the draft, as indicated in its letter of transmittal to the Congress dated April 3, 1963, covering part I of the Report of the Special Study (see: pt. 5 of the study report at p. 4), had not reached a final determination with respect to all of the subsidiary questions as to the exact form of the legislation. An important purpose of submitting the draft to the industry liaison committee was to obtain reactions and comment which might be of assistance in arriving at these determinations.

The draft was thereafter discussed in a series of meetings late in April and in May, following which the bill was introduced in the House and Senate on June 4, 1963. This memorandum will compare the provisions of the draft so submitted on April 19 and the bill as so introduced. In so doing it will consider, first, changes in the provisions relating to disclosure requirements for larger companies in the over-the-counter market and, second, provisions dealing with qualifications to enter the securities business, and disciplinary proceedings against brokers, dealers, and their personnel. These two types of proposals have generally been discussed separately during congressional consideration of this legislation.

At the outset, three additional circumstances should be noted. In the first place, during the period from April 19 to June 4, the Commission was not only conducting discussions with the Industry Liaison Committee but also independently reviewing the drafts of the legislation and discussing them with other interested Government agencies. As a result, a number of the changes made during that period are not attributable to the suggestions of the Industry Liaison Committee but resulted from the Commission's own reconsideration or suggestions of other Government agencies. This memorandum will in general discuss only those changes which may be attributable to suggestions of the Industry Liaison Committee.

In the second place, during this same period a number of drafting and language changes were made which were not designed to, and did not, modify the substantive provisions of the proposals but were intended merely to express more clearly the original intention or to meet drafting problems. Some of these drafting changes may be attributable to general suggestions on the part of industry representatives that particular provisions were unclear, while others were made by the draftsmen of the bill independently. In general this memorandum will not discuss drafting changes which did not affect the substance of the proposed legislation.

Finally, since the Industry Liaison Committee was composed of representatives of various independent organizations, none of which had a right to bind any of the others, the committee determined that as a committee it would take no position on any issue but that representatives of the individual organizations would make their own comments and suggestions which representatives of the other organizations might or might not concur with. As a result, on a number of matters a variety of suggestions and proposals were made by various industry representatives, and in some instances suggestions of one industry representative did not meet with agreement by other industry representatives.

PROVISIONS RELATING TO DISCLOSURE IN THE OVER-THE-COUNTER MARKET

All of the organizations represented by the Industry Liaison Committee supported the principle of extending the disclosure requirements to the larger companies in the over-the-counter market, and consequently the discussions dealt primarily with the methods of accomplishing this purpose and the tests to be employed.

A. Tests for coverage

1. The draft submitted to the Industry Liaison Committee would have ultimately applied the disclosure provisions of the Securities Exchange Act to issuers in the over-the-counter market having a class of equity securities held of record by more than 300 persons, in conformity with the recommendations of the Special Study. Also in conformity with the Special Study recommendations, there would have been a transitional period during which these requirements would have applied successively to companies having more than 750 stockholders and more than 500 stockholders. Industry representatives felt that the 300 stockholder figure was too low and suggested that the legislation apply only to issuers

having more than 1,000 stockholders. Various industry representatives also advanced a variety of other possible tests based upon assets, earnings, the number of shares outstanding, and the number of shares in public hands.

Following the discussions with industry, the Commission independently reexamined the entire question and evolved the standard contained in H.R. 6789 as introduced, i.e., ultimate application to companies having $1 million of assets and 500 stockholders or more. In arriving at this conclusion the Commission estimated, based on figures compiled by the Special Study, and other information available to it, that the 500 stockholder test would thus reach those companies in which the bulk of public investors in over-the-counter companies had an interest, even though it must be recognized that those who invest in smaller companies are equally in need of protection. The $1 million asset test was evolved by the Commission, primarily in the belief that in the case of companies having less than $1 million of assets the expense to the issuer and the administrative burden upon the Commission would outweigh the benefits to stockholders which would result.

2. At the suggestion of industry representatives section 12(g) was revised to give issuers 120 days after the close of the fiscal year in which they qualify to meet the number of stockholders and asset tests within which to file a registration statement; and section 18 liability was not to attach until the registration became effective. This provides such issuers with a transition period and averts civil liability because of inadvertent violation.

3. The proposal as submitted to the Industry Liaison Committee would have required that copies of the reports be filed with various offices of the Commission, offices of the National Association of Securities Dealers, Inc., and financial manuals. This was designed to bring about wider dissemination of information. The NASD expressed a reluctance to handle these reports and industry representatives suggested that these matters should not be particularized in the statute and that the Commission should administratively arrange for the dissemination of the reports. The Commission accepted this suggestion, and is presently working on the problem.

4. The proposal as submitted to the Industry Liaison Committee contained no statutory exemption for foreign securities but gave the Commission power to exempt them, principally because of the difficulties of enforcement. The Industry Liaison Committee suggested that this might result in disruption of the market for foreign securities while the Commission was considering the question of exemption and accordingly suggested that the statute exempt foreign securities with power in the Commission to subject them to the legislation in appropriate cases. The Commission accepted this suggestion.

5. The proposal for amendment of section 15(d) of the act as submitted to the Industry Liaison Committee would have applied the reporting requirements to every company which filed a registration statement with the Commission, such reporting requirements to continue applicable until no securities of the registered class were outstanding. The bill terminates these requirements when the number of holders falls below 300, consistent with the cutoff provided in section 12(g) of the act as proposed to be amended. At the same time various drafting changes were made in the amendment to section 15(d) of the act.

6. The proposal as submitted to the Industry Liaison Committee would have authorized the Commission to suspend trading in a security registered under amended section 12(g) of the act after notice and hearing if the Commission found that the issuer had failed to comply with the statute. Even before the meeting with the Industry Liaison Committee the Commission concluded that this was not an appropriate remedy, and at the meeting industry representatives suggested that it might impose a hardship upon stockholders. The Commission accordingly modified this proposed amendment of section 15(c)(4) of the act to delete the proposed suspension of trading and substituted, as a sanction, an order requiring compliance by such issuer, which order could subsequently be enforced in judicial proceedings if necessary.

7. The proposal submitted to the Industry Liaison Committee would have authorized the Commission to grant exemptions from the provisions of section 16(b) of the act, which provides for recovery of short-swing profits of "insiders," but did not provide a specific exemption for broker-dealers who maintain an over-the-counter market in securities of a particular issuer and are at the same time represented on the board of directors of that issuer. Some members of the Industry Liaison Committee urged strongly that such an exemption should be of general application and provided directly in the statute. Subsequently, there was sub-

mitted to the Commission an alternative draft which would achieve this result. This alternative draft would vest authority in the Commission to specify terms and conditions for the exemption. Upon further consideration the Commission concluded that the alternative put forward should be accepted.

In reaching this conclusion, the Commission took into account the following factors:

(1) The provision contained in the alternative draft authorizing the Commission to specify terms and conditions for the exemption.

(2) The Commission's general authority over brokers and dealers which would enable it to deal otherwise with insider trading abuses in which they might be involved. See *In the Matter of Cady, Roberts & Co.*, Securities Exchange Act release No. 6668, November 8, 1961.

(3) The fact that broker-dealers would continue to be subject to the reporting requirements of section 16(a), thus affording a continuing review of broker-dealer transactions.

B. Qualifications to enter the securities business, and disciplinary proceedings

The Industry Liaison Committee was also in agreement with the objectives of these provisions and, in general, with their substance, and, accordingly, the discussions dealt primarily with means of accomplishing these objectives.

1. With respect to qualifications to enter the business, the proposed new paragraph 15A(b)(5) of the Securities Exchange Act dealing with the establishment of such qualifications by national securities associations, as included in the draft submitted to the Industry Liaison Committee, required these associations to establish standards of training, experience, and integrity, and to set up "character and fitness" committees. The National Association of Securities Dealers, Inc., felt that it might not be feasible for them to establish standards specifically addressed to "integrity," or to establish character and fitness committees, and accordingly in the bill as introduced, this clause was replaced by a reference to standards with respect to training, experience, and such other qualifications as the association finds necessary or desirable.

No other changes were made insofar as qualifications to enter the business are concerned.

2. In the proposed amendment to section 15(a) of the act, dealing with the requirement of membership in a national securities association, the draft submitted to the Industry Liaison Committee provided for exemption from this requirement by rules of the Commission where there was no association which a particular broker-dealer could join. The Industry Liaison Committee suggested that such exemption be written directly into the statute; and this was done.

3. The draft submitted to the Industry Liaison Committee provided that failure to supervise personnel by a broker-dealer or supervisory employee should be an independent ground for disciplinary proceedings by the Commission against such a broker-dealer or supervisor. The Industry Liaison Committee suggested that if this were to be done, the statute should contain a definition of what constituted failure to supervise as well as more specific criteria, and this was done in the amendments to section 15(b)(2) in the bill as introduced.

4. In the draft as submitted to the Industry Liaison Committee the Commission would have been given, as an additional sanction in disciplinary proceedings, the power to require the closing of a particular branch office of a broker-dealer. The Industry Liaison Committee objected to this proposal on several grounds, particularly that it would be extremely difficult to administer and might lead to unjust results in particular cases. The Commission ultimately concluded that it could deal adequately with the failure to supervise branch office personnel through its new authority to proceed directly against individuals and to utilize more flexible sanctions. Accordingly, this additional sanction was deleted.

5. The Industry Liaison Committee also felt that the Commission should have the power, as the self-regulatory bodies do, to impose a censure as a sanction in disciplinary proceedings; and the Commission accepted this suggestion.

6. In connection with section 15(b)(3) dealing with direct proceedings against individuals in securities firms, the Industry Liaison Committee had two suggestions, which the Commission accepted as being essentially only clarification of existing law: first, that, if the Commission had barred or suspended the right of a person to become associated with a securities firm by reason of specified misconduct, it should have the power to lift such bar; and, second, that it should only be unlawful for a broker-dealer to employ a person who had previously been subjected to such a bar if that broker-dealer knew or, in the exercise of reasonable care, should have known, of the Commission's bar order.

7. Under the existing statute and under the proposals submitted to the Industry Liaison Committee, a broker-dealer may be subjected to disciplinary proceedings by reason of present or prior misconduct of any person controlled by the broker or dealer, including employees. The Industry Liaison Committee suggested that this could lead to unjust results if disciplinary proceedings against a large firm were based upon prior misconduct of clerical or ministerial employees such as elevator operators or janitors, and that the Commission should have power by rules and regulations to classify employees for the purpose of subjecting their employers to disciplinary proceedings. The Commission accepted this suggestion, which is contained in the proposed additional section 3(a)(18) contained in the bill as introduced.

8. In the proposed amendment to section 15A(b)(3) of the bill as submitted to the Industry Liaison Committee, there was no provision dealing with the effect upon eligibility for membership in a national securities association of any prior expulsion or suspension from an exchange. Both the National Association of Securities Dealers, Inc., and the New York Stock Exchange raised this question during discussions with the Industry Liason Committee, and a provision for this purpose, satisfactory to these organizations and the Commission, was included in the amendment to section 15A(b)(3) in the bill as introduced.

9. In connection with Commission review of disciplinary action by a national securities association, members of the Industry Liaison Committee suggested that the filing of an application for review with the Commission should not always stay the action of the association, as is the case under present law, but that the Commision should have authority in appropriate cases to direct that the filing of such an application should not stay the action of the association. This suggestion was agreed to, and a provision to that effect was inserted at the end of the proposed amendments of section 15A(g). The time for filing such an appeal was also reduced from 60 days to 30 days. The reason for these changes was a feeling on the part of industry representatives that some appeals are filed merely for purposes of delay.

10. The proposed amendments submitted to the Industry Liaison Committee would have very substantially expanded the types of rules of a national securities association with respect to which the Commission could require amendment or modification pursuant to section 15A(k) of the act. The Industry Liaison Committee strongly objected to this as a reversal of a decision made by Congress in 1938, when the Maloney Act was adopted, and as an impairment of the initiative and responsibility of such asociations. The point was also made that the NASD as a matter of practice consults regularly with the Commission with respect to its rules and changes therein, and the closer liaison contemplated by the Report of the Special Study would lead to further such consultations. The Commission concluded that it could restrict the amendment of section 15A(k) so as to add the power to modify rules adopted by the association under its new power to determine qualifications for membership and for association with members and that, with respect to the other matters proposed, the Commission would rely upon its own direct rulemaking powers which relate to the prevention of fraud and which have not been fully utilized rather than upon more power to require changes in the rules of the association. It was, however, agreed that an association should be required to adopt rules with reference to quotations for securities, which rules would require the approval of the Commission pursuant to the existing provisions of section 15A (j) and (k) of the act; and such a provision was added by section 7(a)(6) of the bill as introduced.

11. In addition to the foregoing matters which were embraced in the bill as submitted to Congress, the Commission at the same time discussed with industry representatives preliminary drafts of legislation designed to carry out the legislative recommendations of the study with respect to misleading corporate publicity and with respect to the registration and regulation of quotations bureaus. With respect to the proposals on corporate publicity both industry representatives and the Commission were concerned to avoid legislation which would have the effect of inhibiting legitimate corporate disclosure. With respect to quotations bureaus, industry representatives took the position that since the chapters of the Special Study which dealt with this subject had not as yet been completed and made available, it would be premature for industry representatives to express any views except that they did not feel they could support legislation until they had had a chance to review these portions of the study's report. The Commission ultimately concluded not to submit legislation covering

these topics with the rest of the bill. The reasons are stated as follows in the Commission's letter to Congress dated June 5, 1963, transmitting these legislative proposals:

"* * * The material underlying a quotations statute has not yet been delivered to the Congress and, of course, is not available to the securities industry. Under these circumstances, it seems undesirable to submit this legislation until we have had an opportunity to secure the benefit of industry views. Finally, as to legislation on corporate publicity, we have not arrived at a satisfactory formula. Legislation dealing with the above areas may be recommended to the Congress at a subsequent date, but probably not in time for consideration during this session."

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., January 21, 1964.

Hon. HARLEY O. STAGGERS,
House of Representatives,
Washington, D.C.

DEAR MR. STAGGERS: This is with further reference to your letter of December 2, 1963, in which, among other things, you requested a comparative print of the draft of the legislation submitted to the Industry Liaison Committee and the bill as introduced in Congress as H.R. 6789.

In accordance with that request, we enclose herewith two copies of a comparative print of the initial draft as submitted to the Industry Liaison Committee on April 19, 1963, and the legislation introduced in Congress as H.R. 6789 and H.R. 6793 on June 4, 1963. Enclosed with our letter of December 27, 1963, was a memorandum outlining the reasons for the major changes.

I hope that this will meet your needs.

Sincerely,

WILLIAM L. CARY, *Chairman.*

COMPARATIVE PRINT OF THE INITIAL DRAFT BILL FIRST PROPOSED TO THE INDUSTRY LIAISON COMMITTEE AND THE DRAFT SUBMITTED BY THE COMMISSION AND INTRODUCED AS H.R. 6789 AND H.R. 6793 [1]

Sec. 2. Section 3(a) of the Securities Exchange Act of 1934, *as amended,* is amended by adding [the following new paragraphs] at the end thereof *the following four paragraphs*:

"(18) The term 'person associated with a broker or dealer' means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, *including any employee of such broker or dealer. The Commission may by rules and regulations classify, for the purpose of any portion or portions of this title, persons, including employees, controlled by a broker or a dealer. In such rules and regulations the Commission shall appropriately exclude from the scope of subsection (b) (other than paragraph (3) thereof) of section 15 hereof persons associated with a broker or dealer whose functions are clerical or ministerial.*

"(19) The [terms] *term* 'investment company,' *'affiliated person,'* and 'insurance company' have the same meanings as in the Investment Company Act of 1940.

"(20) The [term] *terms* 'investment adviser' and *'underwriter'* [has] *have* the same [meaning] *meanings* as in the Investment Advisers Act of 1940.

"(21) The term 'person associated with a member' means a person who is registered with [the] *a* registered securities association pursuant to its rules or who is associated with a broker or dealer which is a member of such association."

Sec. 3. (a) [That subsection (b) of Section 12 of the Securities Exchange Act be] *Section 12(b) of said Act is* amended [to read] as follows:

(1) Subparagraphs (I) through (K) of paragraph (1) are redesignated as

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[1] Deletions from initial draft prior to submission by the Commission are bracketed; additions to initial draft and incorporated in draft submitted by the Commission are italic.

(J) through (L), respectively.

(2) *A new subparagraph (1)(I) is added to read as follows:*

"(I) material contracts, not made in the ordinary course of business, which are to be executed in whole or in part at or after the filing of the application or which were made not more than two years before such filing and every material patent or contract for a material patent right shall be deemed a material contract."

(3) A new paragraph (3) is added to read as follows:

"(3) Such copies of material contracts, referred to in paragraph (1)(I) above, as the Commission may require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security [, but no disclosure shall be required of any portion of such contract if the Commission determines that disclosure of such portion would impair the value of the contract and would not be necessary for the protection of investors.]"

(*b*) [Subsection (f) of section 12 of the Securities Exchange Act of 1934] *Section 12(f) of said Act* is amended to read as follows:

"(f) Notwithstanding the foregoing provisions of this section, any national securities exchange, subject to the terms and conditions hereinafter set forth, (1) may continue unlisted trading privileges to which a security had been admitted on such exchange prior to the effective date of subsection (g) of section 12 of this title, or (2) upon application to and approval of such application by the Commission, may extend unlisted trading privileges to any security duly listed and registered on any other national securities exchange. If an extension of unlisted trading privileges to a security was originally based upon its listing and registration on another national securities exchange, such privileges shall continue in effect only so long as such securities shall remain listed and registered on any other national securities exchange.

"No application pursuant to this subsection shall be approved unless the Commission finds, after appropriate notice and opportunity for hearing, that the extension of unlisted trading privileges pursuant to such application is necessary or appropriate in the public interest or for the protection of investors.

"The Commission shall by rules and regulations suspend unlisted trading privileges in whole or in part for any or all classes of securities for a period not exceeding twelve months, if it deems such suspension necessary or appropriate in the public interest or for the protection of investors or to prevent evasions of the purposes of this title.

"On the application of the issuer of any security for which unlisted trading privileges on any exchange have been continued or extended pursuant to this subsection, or of any broker or dealer who makes or creates a market for such security, or of any other person having a bona fide interest in the question of termination or suspension of such unlisted trading privileges, or on its own motion, the Commission shall by order terminate, or suspend for a period not exceeding twelve months, such unlisted trading privileges for such security if the Commission finds, after appropriate notice and opportunity for hearing, that such termination or suspension is necessary or appropriate in the public interest or for the protection of investors.

"In any proceeding under this subsection in which appropriate notice and opportunity for hearing are required, notice of not less than ten days to the applicant in such proceeding, to the issuer of the security involved, to the exchange which is seeking to continue or extend or has continued or extended unlisted trading privileges for such security, and to the exchange, if any, on which such security is listed and registered, shall be deemed adequate notice, and any broker or dealer who makes or creates a market for such security, and any other person having a bona fide interest in such proceeding, shall upon application be entitled to be heard.

"Any security for which unlisted trading privileges are continued or extended pursuant to this subsection shall be deemed to be registered on a national securities exchange within the meaning of this title. The powers and duties of the Commission, under subsection (b) of section 19 of this title shall be applicable to the rules of an exchange in respect of any such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions, or for stated periods, exempt such securities from the operation of any provision of section 13, 14, or 16 of this title."

(c) [Section 12 of the Securities Exchange Act of 1934] *Section 12 of said Act* is *further* amended by adding thereto the following new subsection:

"(g)(1) Every issuer which [has a class of equity securities (other than exempted securities) held of record by 300 or more persons and] *is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are* traded by use of the mails or any means or instrumentality of interstate commerce shall—

"(i) *within one hundred and twenty days after the last day of its fiscal year ended after the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and*

"(ii) *within one hundred and twenty days after the last day of its fiscal year ended after two years from the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons*

[file] *register such security by filing* with the Commission a registration statement (*and such duplicate originals as the Commission may require*) with respect to such [securities] *security* containing such information and documents as *the Commission* may [be] *specify comparable to that which is* required in an application to register a security pursuant to subsection (b) of this section. [Duplicate copies of such registration statement shall be filed with such offices of the Commission and of each national securities association, recognized financial manuals and such other persons as may be prescribed by the Commission.] *Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 18 of this title.* Any issuer may register any class of [its] equity [securities] *security* not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. *The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.*

"(2) The provisions of this subsection shall not apply in respect of—

"(A) any security listed and registered on a national securities exchange;

"(B) any security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940;

"(C) any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawable capital, issued by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution; [or]

"(D) any security of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual; *or*

"(*E*) *any security of a foreign issuer, including any certificate of deposit for such a security, unless the Commission, by rules or regulations, or by order after notice and opportunity for hearing, on its own motion or upon application of an interested person, finds that a substantial public market for the equity securities of such issuer or of a class of issuers which includes such issuer exists in the United States and that continued exemption of securities of such issuer or class of issuers is not in the public interest or consistent with the protection of investors.*

[(3) The provisions of section 13, section 14, section 16 and subsection (c) of section 20 of this title shall apply as if any security of a class registered or required to be registered pursuant to this subsection were a security registered pursuant to subsection (b) of this section. Duplicate copies of information, documents and reports required hereunder shall be filed with such offices of the Commission and of each national securities association, recognized financial manuals and such other persons as may be prescribed by the Commission.]

"(*3*)[5] Registration of any class of [securities] *security* pursuant to this subsection shall be terminated [90] *ninety* days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced

to less than [200] *three hundred* persons. The Commission shall after notice and opportunity for hearing deny termination of registration if it finds that the [facts certified to it are false] *certification is untrue*. Termination of registration shall be deferred pending final determination on the question of denial.

"*(4) For the purposes of this subsection the term 'class' shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges.* The Commission may, [as it deems necessary or appropriate in the public interest,] *for the purpose of this subsection define* by rules and regulations [define] the terms *'total assets' and* 'held of record' [and "class" and any other terms for the purposes of this subsection] *as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection.*"

(d) Section 12 of said Act is further amended by adding thereto the following new subsection:

"*(h)*[(6)] The Commission may by rules and regulations, or upon application of an interested person, *by order*, after notice and opportunity for hearing, [by order] exempt *in whole or in part* any [person or any class of securities] *issuer or class of issuers* from [any provision or] *the* provisions of [this] subsection *(g) hereof or from sections 13, 14, or subsection 15(d) of this title or may exempt from section 16 hereof any officer, director, or beneficial owner of securities of any issuer, any security of which is required to be registered pursuant to subsection (g) hereof*, upon such terms and conditions and for such period as it [finds] *deems* necessary or appropriate, [in the public interest and not inconsistent with the protection of investors, or] if the Commission finds, *by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise*, that [the provisions of this subsection may not be susceptible of enforcement against foreign issues and issuers] *such action is not inconsistent with the public interest or the protection of investors. The Commission may, for the purposes of any of the above-mentioned sections or subsections of this title classify issuers and prescribe requirements appropriate for each such class.*"

[(7) This subsection shall be effective on ———— provided, however, that prior to ——— days after the effective date of this subsection no issuer shall be required to register any class of securities held of record by less than 750 persons and provided further that prior to ——— days after the effective date of this subsection no issuer shall be required to register any class of securities held of record by less than 500 persons."]

(e) Section 12 of said Act is further amended by adding thereto the following new subsection:

"*(i)*[(8)] In respect of any [security] *securities* issued by [a bank all] *banks* the powers, functions, and duties of the Commission pursuant to the provisions of this [subsection] *title* shall [vest] *be delegated* in [(the appropriate federal banking regulatory authority)] *whole or in part to the federal banking regulatory agency or instrumentality which has jurisdiction to examine or supervise the business of such banks, upon the request of such agency or instrumentality.*"

Sec. 4. Section 13(a) of said Act is amended to read as follows:

"*(a) Every issuer of a security registered pursuant to section 12 of this title shall file with the Commission the information, documents, and reports below specified (and such duplicate originals as the Commission may require) in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the securities—*

"*(1) Such information and documents as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 12.*

"*(2) Such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports, as the Commission may prescribe.*

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange."

Sec. 5(a) Section 14(a) of said Act is amended to read as follows:

"*(a) It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title.*"

(*b*) [Section 14 of the Securities Exchange Act of 1934] *Section 14(b) of said Act* is amended to read as follows:

"(b) It shall be unlawful for any member of a national securities exchange, or any registered broker or dealer, [to give, or to refrain from giving a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer] in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, *to give, or to refrain from giving a proxy consent, or authorization in respect of any security registered pursuant to section 12 of this title and carried for the account of a customer.*"

(*c*) *Section 14 of said Act is further amended by adding thereto the following new subsection:*

"(c) [It shall be unlawful for any issuer of any security (other than an exempted security) registered on a national securities exchange to hold any annual or other meeting of the holders of such security unless either (i)] *Unless* proxies, consents, or authorizations in respect of [such] *a* security [for such meeting] *registered pursuant to section 12 of this title* are solicited by or on behalf of the management of the issuer from [all] *the* record holders of such security in accordance with subsection (a) of this section and the rules and regulations thereunder, [or (ii)] *prior to any annual or other meeting of the holders of such security,* such issuer shall, in accordance with rules and regulations prescribed by the Commission, [prior to such meeting] file with the Commission and transmit to all record holders of such security information substantially equivalent to the information which would be required to be transmitted if a solicitation were made."

Sec. 6. (a) Section [15 of the Securities Exchange Act of 1934] *15(a) of said Act* is amended to read as follows:

"(a) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than exempted security or commercial paper, [bankers'] *banker's* acceptances, or commercial bills) otherwise than on a national securities exchange, unless [(A)] such broker or dealer [*A*] is registered in accordance with subsection (b) of this section, and (B) is a member of a securities association which is registered pursuant to section 15A of this title.

"The Commission may by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for specified periods, exempt from [clause (B)] *clauses (A) or (B), or both,* of this subsection (a) any broker or dealer or category of brokers or dealers specified in such rules, regulations, or orders. [The Commission shall by rule or regulation, exempt from clause (B) of this subsection (a):] *Clause (B) of this subsection (a) shall be inapplicable with respect to:* (i) all brokers and dealers during any period in which there is no registered securities association, and (ii) any broker or dealer during any period in which the rules of each registered securities association preclude the membership therein of such broker or dealer solely because of the geographical location of, or type of business done by, such broker or dealer."

(*b*) *Section 15(b) of said Act is amended to read as follows:*

"(b)(1) A broker or dealer may be registered for the [purpose] *purposes* of this section by filing with the Commission an application for registration, which shall contain such information in such detail as to such broker or dealer and any persons associated with such broker or dealer as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective [30] *thirty* days after the receipt of such applica-

tion by the Commission or within such shorter period of time as the Commission may determine.

"An application for registration of a broker or dealer to be formed or organized may be made by a broker or dealer to which the broker or dealer to be formed or organized is to be the successor. Such application shall contain such information in such detail as to the applicant and as to the successor and any person associated with the applicant or the successor, as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine. Such registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Commission may prescribe, adopt such application as its own.

"If any amendment to any application for registration pursuant to this subsection is filed prior to the effective date thereof, such amendment shall be deemed to have been filed simultaneously with and as part of such application; except that the Commission may, if it appears necessary or appropriate in the public interest or for the protection of investors, defer the effective date of any such registration as thus amended until the thirtieth day after the filing of such amendment.

"Any provision of this title (other than section 5 and subsection (a) of this [Section] *section* 15) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any broker or dealer registered pursuant to this subsection or any person acting on behalf of such a broker or dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

"(2) The Commission shall, after appropriate notice and opportunity for hearing, by order *censure*, deny registration to, suspend for a period not exceeding [12] *twelve* months or revoke the registration of, any broker or dealer if it finds that such *censure*, denial, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming [such] *so associated*, (A) has willfully made or caused to be made in any application for registration or report *required to be* filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, *or has omitted to state in any such application or report any material fact* which is required to be stated therein; or (B) has been convicted within ten years preceding the filing of [any such] *the* application or at any time thereafter of any felony or misdemeanor which the Commission finds: (i) involves the purchase or sale of any security, (ii) arises out of the conduct of the business of a broker, dealer, or investment adviser, (iii) involves embezzlement, fraudulent conversion, or misappropriation of funds or securities, or (iv) involves the violation of section 1341, 1342, or 1343 of title 18, United States Code, as heretofore or hereafter amended; or (C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, *underwriter*, broker or dealer, or [from being associated with] *as an affiliated person or employee of* any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security; or (D) has willfully violated any provision of the Securities Act of 1933, or of the Investment Advisers Act of 1940, or of the Investment Company Act of 1940, or of this title, as any of such statutes heretofore have been or hereafter may be amended, or of any rule or regulation under any of such statutes; or (E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Investment Advisers Act of 1940, or the Investment Company Act of 1940, or of this title, as any such statutes heretofore have been or hereafter may be amended, or of any rule or regulation [thereunder] *under any of such statutes* or has failed reasonably to supervise, *with a view to preventing violations of such statutes, rules and regulations, another person who commits such*

a violation, if such other person *is subject to his supervision*; or (F) is subject to an order of the Commission entered pursuant to paragraph (3) of this subsection (b) barring or suspending the right of such person to be associated with a broker or dealer, which order is in effect with respect to such person. *For the purposes of clause (E) of this paragraph, no persons shall be deemed to have failed reasonably to supervise any person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person; and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.* Pending final determination whether any such registration shall be denied, the Commission may by order postpone the effective date of such registration for a period not to exceed fifteen days, but if, after appropriate notice and opportunity for hearing (which may consist solely of affidavits and oral arguments), it shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors to postpone the effective date of such registration until final determination, the Commission shall [so] order (sic). Pending final determination whether any such registration shall be revoked, the Commission shall by order suspend such registration if, after appropriate notice and opportunity for hearing, such suspension shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors. Any registered broker or dealer may, upon such terms and conditions as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered broker or dealer, or any broker or dealer for whom an application for registration is pending, is no longer in existence or has ceased to do business as a broker or dealer, the Commission shall by order cancel the registration or application of such broker or dealer.

[“If the Commission finds that such action is in the public interest and that a broker or dealer has failed reasonably to supervise the operations of one or more branch offices, it may, in lieu of revoking or suspending for up to 12 months the registration of such broker or dealer or in addition to such suspension pursuant to the foregoing provisions of this subsection (b)(2), by order require such broker or dealer to close such branch office or offices of such broker or dealer as are specified in such order. If the Commission has entered such an order, it shall be unlawful for such broker or dealer, except with the approval of the Commission, to thereafter open or operate a branch office in the city, town, community or area or the portion of any of them served by a branch office closed pursuant to such order. For purposes of the foregoing provisions the portion of a city, town, community, or area served by such a branch office shall mean the portion of the city, town, community, or area which was served by a branch office ordered to be closed as above provided, as distinct from any other office of such broker or dealer. In case the prohibitions upon the operation of a branch office hereinabove provided is to be applicable within a portion of a city, town, community or area, the Commission shall in its order specify and describe such portion.]

“(3) The Commission may, after appropriate notice and opportunity for hearing, by order *censure any person, or* bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer, if the Commission finds that such *censure*, barring or suspension is in the public interest and that such person has committed *or omitted* any act *or omission* enumerated in [Clauses] *clauses* (A), (D), or (E) of [subsection] *paragraph* (2) [hereof] *of this subsection (b) hereof* or has been convicted of any offense specified in clause (B) of said [subsection] *paragraph* (2) hereof or is enjoined from any action, conduct, or practice specified in [Clause] *clause* (C) of said [subsection] *paragraph* (2). It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with a broker-dealer is in effect, willfully to become, or to be, associated with a broker or dealer, *without the consent of the Commission*, and it shall be unlawful for any broker or dealer [willfully] to permit such a person to become, *or remain*, a person assciated with him, *without the consent of the Commission, if such broker or dealer knew, or in the exercise of reasonable care, should have known, of such order.*”

(c) [Section 15 of the Securities Exchange Act of 1934] *Section 15(c) of said Act* is amended by adding [to subsection (c)] *at the end* thereof the following new paragraphs:

"(4) [The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors, after appropriate] *If the Commission finds, after* notice and opportunity for hearing, [by order to suspend trading otherwise than on a national securities exchange in any security registered or required to be registered pursuant to section 12 of this title or with respect to which the issuer is required to file reports pursuant to an undertaking required under subsection (d) of this section, if the Commission finds that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder] *that any person subject to the provisions of sections 12, 13 or subsection (d) of section 15 of this title or any rule or regulations thereunder has failed to comply with any such provision, rule or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person to comply with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.*

"(5) If in its opinion the public interest and the protection of investors so [requires] *require*, the Commission is authorized summarily to suspend trading, otherwise than on a national securities exchange, in any security (other than an exempted security) for a period not exceeding ten days. No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in which trading is so suspended."

(*d*) [Subsection (d) of section 15 of the Securities Exchange Act of 1934] *Section 15(d) of said Act* is amended to read as follows:

"(d) Each [registration statement hereafter filed pursuant to the Securities Act of 1933, as amended, shall contain an undertaking by the issuer of the issue of securities to which the registration statement relates to file with the Commission] *issuer which has filed a registration statement containing an undertaking which is or becomes opertaive under this subsection as heretofore in effect, and each issuer which shall hereafter file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission*, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title in respect of a security [listed and] registered [on a national securities exchange] *pursuant to section 12 of this title.* [Such undertaking shall become operative on the effective date of the registration statement. The issuer shall file such supplementary and periodic information, documentation and reports pursuant to such undertaking, except that the] *The* duty to file *under this subsection* shall be automatically suspended if and so long as (1) [such] *any* issue of securities *of such issuer* is [listed and] registered [on a national securities exchange] *pursuant to section 12 of this title, or* [(2) by reason of the listing and registration of any other security of such issuer on a national securities exchange, or the registration of any security of such issuer pursuant to subsection (g) of section 12 of this title, such issuer is required to file pursuant to section 13 of this title information, documents and reports substantially equivalent to such as would be required if such issue of securities were listed and registered on a national securities exchange,] (2) *the securities of each class to which the registration statement relates are held of record by less than three hundred persons at the end of its last fiscal year subsequent to the conclusion of the offering and immediately preceding the date on which such information, documents, and reports would otherwise be required to be filed* [or (3) no security to which the registration statement relates is outstanding]. *For the purposes of this subsection, the term 'class' shall be construed to include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges.* Nothing in this subsection shall apply to securities issued by a foreign government or political subdivision thereof [or to any other security which the Commission may by rules and regulations exempt as not comprehended within the purposes of this subsection]."

SEC. 7. (*a*) Section [15A of the Securities Exchange Act of 1934] *15A(b) of said Act* is amended as follows:

(*1*) Paragraph (3) [of subsection (b)] *thereof* is amended to read *as follows:*

"(3) the rules of the association provide that any broker or dealer who makes use of the mails or [of] any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, may become a member of such association, except such as are excluded pursuant to paragraphs (4) and (5) of this subsection: Provided, That the rules of the association may restrict membership in such association on such specified geographical basis, or on such specified basis relating to the type of business done by its members, or on such other specified and appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purpose of this section; *rules adopted by the association may provide that the association may, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, deny admission to or refuse to continue in such association any broker or dealer if (i) such broker or dealer, whether prior or subsequent to becoming such, or (ii) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, has been and is suspended or expelled from a national securities exchange or has been and is barred or suspended from being associated with all members of such exchange, for violation of any rule of such exchange;*".

(*2*) Paragraph (4) [of subsection (b)] *thereof* is amended to read as follows:

"(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued *in membership* in such association, if (i) such broker or dealer, whether prior or subsequent to becoming such, or [(2)] (*ii*) any person associated with such broker or dealer, whether prior or subsequent to becoming [such] *so associated* (A) has been and is suspended or expelled from a registered securities association (whether national or affiliated) or from a national securities exchange or has been and is barred or suspended from being associated with [a member] *all members* of such association or [exchange] *from being associated with all brokers or dealers which are members of such exchange*, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade, or (B) is subject to an order of the Commission denying, suspending for a period not exceeding [12] *twelve* months or revoking his registration pursuant to [Section] *section* 15 of this title, or expelling or suspending him from membership in a registered securities association or *a* national securities exchange, or barring or suspending him from being associated with a broker or dealer, or (C) by his conduct while associated with a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in [Clauses] *clause* (A) or (B) which is in effect *with respect* [in regard] to such broker or dealer, and in entering such [an] *a suspension, expulsion or* order, the Commission or any such exchange or association shall have jurisdiction to determine whether or not any person was a cause thereof;".

(*3*) [Paragraph (5) of subsection (b) is renumbered paragraph (6) and subsequent paragraphs of subsections are renumbered accordingly] *Paragraphs (5) through (10) thereof are redesignated as paragraphs (6) through (11), respectively,* and a new paragraph (5) is added to read as follows:

"(5) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall become a member [or] *and no natural person shall become a person* associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and [integrity of such person] *such other qualifications of such persons as the association finds necessary or desirable*, and in the case of a member, the financial responsi-

bility of such member. For the purpose of defining such standards and the application thereof, such rules may (A) appropriately classify prospective members *(taking into account relevant matters, including type of business done and nature of securities sold)* and persons proposed to be associated with members, (B) specify that all or any portion of such standards shall be applicable to any such class, (C) require persons in any such class to pass examinations prescribed in accordance with such rules, (D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and [integrity] *such other qualifications as the association finds appropriate,* (E) [provide for the establishment of character and fitness committees charged with passing upon the integrity of prospective members or persons associated with such members,] *provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to the training, experience, financial responsibility, and other qualifications of the applicant and that the association may adopt procedures for verification of qualifications of the applicant,* and (F) require any class of persons associated with a member to be registered with the association in accordance with procedures specified by such rules (and any application or document supplemental thereto required by such [procedures] *rules* of a person seeking to be registered with such association shall, for the purposes of subsection (a) of section 32 of this title, be deemed an application required *to be filed under* [by] this title)."

(4) [Present paragraph (8) (to be renumbered (9)) of subsection (b)] *Redesignated paragraph (9)* is amended to read as follows:

"(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, [suspension] or being suspended or barred from being associated with [a member] *all members,* or any other fitting penalty, for any violation of its rules;".

(5) [Present paragraph (9) (to be renumbered 10) of subsection (b)] *Redesignated paragraph (14)* (sic) is amended to read as follows:

"(10) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules shall require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include (A) a statement setting forth any act or practice in which such member or other person may be found to have engaged, or which such member *or other person* may be found to have omitted, (B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation, (C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade, and (D) a statement setting forth the penalty imposed. In any proceeding to determine whether a broker or dealer shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the broker or dealer or person shall be notified of, and be given an opportunity to be heard upon, the specific grounds for denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based; and".

(6) Section 15A(b) is further amended by adding two unnumbered paragraphs at the end thereof, to read as follows:

"The rules of the association shall include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be disseminated by any member or any person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent

fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations.

"*Provided, however,* That the rules of a registered securities association which was registered on the effective date of the amendments to this subsection (b) contained in Public Law *Numbered* [No.] need not conform to the requirements of such subsection as so amended until 1964. After 1964, the Commission may, after notice and opportunity for hearing, suspend the registration of any such association if it finds that the rules do not conform to the requirements of this subsection (b) as so amended and any such suspension shall remain in effect until the Commission issues an order determining that such rules have been modified to conform with the requirements of this subsection (b) as so amended."

(*b*) Section 15A(d)(2) is amended by striking the figure "(9)" inserting in lieu thereof "(10)".

(*c*) [Subsection (g) and (h) of subsection 15A are] *Section 15A(g)* is amended to read as follows:

"(g) If any registered securities association (whether national or affiliated) shall take any disciplinary action against any member thereof or any person associated with such member or [,] shall deny admission to any broker or dealer seeking membership therein, or shall bar any person from being associated with a member, such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within [sixty] *thirty* days after such action has been taken or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall operate as a stay of such action until an order is issued upon such review pursuant to subsection (h), *unless the Commission shall otherwise order, after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments).*"

(*d*) *Section 15A(h) is amended to read as follows:*

"(h)(1) In a proceeding to review disciplinary action taken by a registered securities association against a member thereof or a person associated with a member, if the Commission, after appropriate notice and opportunity for hearing, upon consideration of the record before the association and such other evidence as it may deem relevant, shall (A) find that such member or person has engaged in such acts or practices, or has omitted such act, as the association has found him to have engaged in or omitted, and (B) shall determine that such acts or practices, or omission to act, are in violation of such rules of the association as have been designated in the determination of the association, the Commission shall by order dismiss the proceeding, unless it appears to the Commission that such action should be modified in accordance with paragraph (2) of this subsection. The Commission shall likewise determine whether the acts or practices prohibited, or the omission of any act required, by any such rule constitute conduct inconsistent with just and equitable principles of trade, and shall so declare. If it appears to the Commission that the evidence does not warrant the finding required in clause (A) or if the Commission shall determine that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the association, or that such act as is found to have been omitted [,] is not required by such designated rule or rules, the Commission shall by order set aside the action of the association.

"(2) If, after appropriate notice and opportunity for hearing, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

"(3) In any [proceedings] *proceeding* to review the denial of membership in a registered securities association or barring any person from being associated with a member, if the Commission, after appropriate notice and hearing, and upon consideration of the record before the association and such other evidence as it may deem relevant, shall determine that the specific grounds on which such denial or bar is based exist in fact and are valid under this section, the Commission shall by order dismiss the [proceedings] *proceeding;* otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant broker or dealer to membership therein, or to permit such person to be associated with a member."

(*e*) [Paragraph (2) of subsection (k) of Section 15A] *Section 15A(k)(2)* is amended to read as follows:

"(2) The Commission may *in writing* request [a] *any* registered securities asssociation to adopt [changes or additions] *any specified alternation of or supplement* to its rules *with respect to any of the matters hereinafter enumerated.* If [the] *such* association fails *to adopt such alternation or supplement* within a reasonable time, [fixed by the Commission to adopt the requested changes or additions, and if the Commission finds that the requested, or similar or related, changes or additions are necessary or appropriate in the public interest or to carry out the purposes of this section, the Commission may] *the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modifications of such alternation or supplement as it deems necessary if,* after appropriate notice and opportunity for hearing, [order the requested, or similar or related, changes or additions adopted, in respect of any matter, including:] *it appears to the Commission that such alternation or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section, with respect to:* [(1)] (*A*) The basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member [or] *of* (sic) the disciplining of members or persons associated with members, or the qualifications required for members or persons associated with members, or any class thereof; [(2)] (*B*) the method for adoption of any change in or addition to the rules of the association; [(3)] (*C*) the method of choosing officers and directors; [(4)] *and* (*D*) affiliation between registered securities association." [; (5) safeguards in respect of the financial responsibility of members; (6) the time and method of making settlements, payments, deliveries, and of closing accounts; (7) hours of trading; (8) transmission to a customer of a member of proxies, consents, authorizations and related materials received by such member in respect of securities carried for the account of such customer by such member; (9) the manner, method, and place of soliciting business, or disseminating advice, analyses, or reports concerning securities or their value; (10) supervision by a member of persons associated with such member; (11) participation by a member in the primary or secondary distribution of securities, and trading by members in securities which are the subject of such distributions; (12) time and manner of furnishing, and contents of, confirmations, statements and similar documents to customers by members; (13) records (and contents thereof) to be made and retained by members and persons associated with members; reports to be made by members to the association; and records to be made available for public inspection by the association; (14) the fixing of reasonable rates of commission, interest, and other charges, the fairness of prices charged, and disclosures with respect thereto; (15) the making of primary markets in securities by members; (16) the collection and publication of quotations, and (17) similar matters."]

(*f*) [Paragraph (2) of subsection (1) of Section 15A] *Section 15A(1)(2)* is amended to read as follows:

"(2) [After] *after* appropriate notice and opportunity for hearing, by order to suspend [,] for a period not exceeding [12] twelve months or to expel from a registered securities association any member thereof, or to suspend for a period not exceeding [12] twelve months or to bar any person from being associated with a member thereof, if the Commission finds [(A)] that such member or person (*A*) has violated any provision of this title or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this title or any rule or regulation thereunder, or (B) has willfully violated any provision of the Securities Act of 1933, as amended, or of any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was willfully violating with respect to such transaction any provision of such Act or rule or regulation."

Sec. 8. (a) Section 16(a) of said Act is amended to read as follows:

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to subsection (g) of section

12 of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange) a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

(b) Section 16 of said Act is further amended by redesignating subsection (d) thereof as (e) and adding a new subsection (d) as follows:

"(d) The provisions of subsection (b) of this section shall not apply to any purchase and sale, or sale and purchase, and the provisions of subsection (c) of this section shall not apply to any sale, of an equity security not then or theretofore held by him in an investment account, by a broker or dealer in the ordinary course of his business and incident to the establishment or maintenance of a primary or secondary market for such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, define and prescribe terms and conditions with respect to securities held in an investment account and transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market."

Sec. 9. Section 20(c) of said Act is amended to read as follows:

"(c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, and issuer required to file any document, report, or information under this title or any rule or regulaiton thereunder without just cause to hinder, delay, or obstruct the making of filing of any such document, report, or information."

Sec. 10. Section 32 of said Act is amended by striking subsection (b) thereof and by redesignating subsection (c) thereof as "(b)".

Sec. 11. Section 4 of the Securities Act of 1933, as amended, is amended to read as follows:

"The provisions of section 5 shall not apply to any of the following transactions:

"(1) Transactions by any person other than an issuers, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except (a) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter, (b) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), *or such shorter period as the Commission may specify by rules and regulations or order* and (c) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter. [The period specified in subparagraph (b) shall be ninety days in respect of transactions in a security of an issuer, a security of which has] *With respect to transactions referred to in subparagraph (b), if securities of the issuer have* not previously been sold pursuant to an *earlier* effective registration statement [, provided, however, that either period may be shortened as the Commission may determine] *the applicable period, instead of forty days shall be ninety days, or such shorter period as the Commission may specify* by rules and regulations or [by] order.

"(2) Brokers' transactions, executed upon customers' orders on any exchange or in the over-the-counter market, but not the solicitation of such orders."

Sec. 12. The amendment made by this Act shall take effect as follows:

(1) The effective date of subsection 12(g)(1) of the Securities Exchange Act of 1934, as added by the Securities Act Amendments of 1963, shall be July 1 1964.

(2) The effective date of the amendments to section 15(a) of said Act contained in the Securities Acts Amendments of 1963 shall be July 1, 1964.

(3) The amendments to section 15(d) of said Act contained in the Securities Acts Amendments of 1963 shall apply to every registration statement pursuant to the Securities Act of 1933 which becomes effective after the date of enactment of said amendments.

(4) All other amendments contained in the Securities Acts Amendments of 1963 shall take effect on the date of enactment.

Mr. STAGGERS. Back to you, Mr. Lemkau. If I may. One of the new proposals contained in the bills before us is that all registered broker-dealers will be required to join a national securities association either in the NASD or another association. I wish you would comment upon the advantages or disadvantages of making this membership mandatory rather than voluntary as at present? I know that you discussed it briefly with Mr. Glenn but I wish you would give us the benefit of your views now.

Mr. LEMKAU. It seems to the board that self-regulation is a good thing.

It can get into the ethics of the business where law perhaps cannot reach. If you are going to have broker-dealers in the securities business who are outside of the NASD having different requirements for entrance into that business, having different standards and not having the inspection of the self-regulatory agency, you may have activities that reflect on those who are members of the NASD. Their actions might not conform to what we consider proper principles of trade. Therefore, we have no objection if they wish to join our association and if they are forced to join an association we have no objection to their joining our own. We do think that if they do not wish to join our association provision is in the law that they may set up an association of their own. However, if it is an affiliated association as defined in the act today, I believe it has to have the same requirements, tests as our present association has.

Mr. STAGGERS. My question was not whether to join yours or another one, but what would be the advantages or disadvantages of compelling them to join an association or leaving it as at present, on a voluntary basis? What are the advantages or disadvantages is what I am trying to get for the committee record.

Mr. LEMKAU. It is just to have the additional regulation of self-regulation for other people, people who are not members of the NASD.

Mr. STAGGERS. They can say they can self-regulate themselves.

Mr. LEMKAU. You mean each individual firm could self-regulate itself? That could be.

Mr. STAGGERS. Are you in favor of this compulsory of joining of an association or not?

Mr. LEMKAU. I feel that the board has taken the position that all people in the securities business should be under self-regulation. We have not stated that we feel they should mandatorily have to join our self-regulated body.

Mr. STAGGERS. I think we are a little amiss in our understanding. I don't care about the self-regulation part. That would be true whether in your organization or another organization. What is your opinion should there be some self-regulatory agency or should there be independent operation in Washington or someplace else?

Mr. LEMKAU. I think they should be members of an association.

Mr. STAGGERS. The reason I asked for the advantages or disadvantages of being in the organization or outside. I believe you have answered it by your testimony somewhat today, but would you care to comment again on it? What would this mean to the investing public and to the country and to others involved?

Mr. LEMKAU. The purpose of the self-regulatory organization is to protect the public. Insofar as the NASD is concerned we have set up these procedures and inspections to insure that our members are fair in their dealings with the public. We believe that anyone in the securities business should have a similar check on the activities of its members.

Mr. STAGGERS. There are some who have "the public be damned" attitude. "If I can do this or that I am free to do as I please as long as I obey certain laws or certain standards." What I was trying to get to is what is the advantage to our people and the reasons for saying that the provisions of this bill should be there or why they should not be there. That is what I was trying to get at. I think perhaps you have answered it to a certain degree.

Mr. LEMKAU. It seems to us to have anybody in the business who is not conducting himself in an ethical manner is going to reflect on the whole business.

Mr. STAGGERS. There are different standards of ethics, too.

Mr. LEMKAU. I think that is true.

Mr. STAGGERS. I think that might be one of the advantages, might it not, of course in an organization?

Mr. LEMKAU. That is our feeling.

Mr. STAGGERS. That is what I was wondering if that might not be the big advantage. We have our standards, all of us, but some of them might not be up to our par.

Mr. LEMKAU. That is right.

Mr. STAGGERS. In September 1961, the NASD board of governors established a special committee to review all offerings of unseasoned companies to determine whether the underwriting arrangements are fair and consistent with just and equitable principles of trade under the NASD's rules of practice. What factors does that committee apply in determining whether the underwriting arrangements are reasonable or not?

Mr. LEMKAU. That committee was established when we found there were some members of the NASD who were charging small companies in new underwritings, during that era, what just seemed obviously inordinate underwriting fees. The committee was asked to take—this is in our manual, Mr. Chairman—the committee was asked to take into consideration the size of the underwriting—page 59 of the interpretations, policies, and explanations of the NASD manual. The general guidelines there, the committee takes into consideration the size of the underwriting, whether the issue was being sold on a firm commitment, best efforts, or all-or-none basis, the type of securities offered, and various other factors.

In determining the amount of the underwriter's compensation, the committee includes the gross amount of the underwriter's discount, total expenses payable by the issuer to or on behalf of the underwriter which normally would be paid by the underwriter are included. The committee may, however, exclude offsetting expenses normally borne

by the issuer, such as printing costs, registration fees, and accountant fees, which are in fact paid by the underwriter. The committee includes underwriter counsel fees and expenses and finders fees when paid by the issuer or person in control of or in common control with the issuer.

Stock acquired or to be acquired by the underwriter, finder or related parties in connection with the offering is valued on the basis of the difference between the cost of such stock and the public offering price. However, the fact that the stock has been held or that assurances have been given that it will be held for a substantial period of time and the method of payment there for may alter the approximate valuation placed thereon. The committee arrives at a business judgment in determining the value of options or warrants to the underwriter, finder, or related parties, taking into account the number and term of the warrants, their exercise price or prices, the date on which they become exercisable and/or transferrable, and such other factors.

Mr. STAGGERS. I think in relationship to that, is this the report of the committee study or is this the charge to the committee?

Mr. LEMKAU. This is instructions to the membership.

Mr. STAGGERS. They have not reported back yet?

Mr. LEMKAU. They have not what?

Mr. STAGGERS. They have—this is instructions from the committee to the membership?

Mr. LEMKAU. That is right, that is from our committee to the membership. It is labeled "general guideline."

Mr. STAGGERS. Does the NASD have any minimum capital or bonding requirements for broker-dealer firms?

Mr. LEMKAU. We do not at the present time, no, sir.

Mr. STAGGERS. Could it impose such requirements under existing law?

Mr. WHITE. In 1942 the Commission had before it a proposal by the association that the association be permitted to have minimum net capital of $5,000 for general members and $2,500 for members who dealt exclusively in mutual funds. The Securities and Exchange Commission rendered an opinion in 1942 or 1943, stating that in their view—the then Commission stated—that they did not believe the association had the authority to adopt a minimum net capital. As Commissioner Whitney said, the present Commission takes the view that the association should have such a rule but at least in the lawbooks it was not the opinion of the Commission back in the forties. As to bonding requirements I think we have made studies of those and its related subjects and I believe we would have to discuss with the Commission our authority in that area.

Mr. STAGGERS. Under the present legislative proposals, would they have that authority?

Mr. WHITE. I believe the language is financial requirements and I think we could extend it that far.

Mr. STAGGERS. The SEC staff study stated that the NASD made no independent check of the good character of newly registered employees, relying on the diligence of member firms to make this investigation. Is this true?

Mr. LEMKAU. That is correct, Mr. Chairman.

Mr. STAGGERS. Does NASD prescribe any minimum period of training for salesmen as is required by the law on the New York Stock Exchange?

Mr. LEMKAU. No; we do not have any training period.

Mr. ROCKEFELLER. There is no experience requirement.

Mr. STAGGERS. Do you believe that a special examination for salesmen selling special types of securities—for example, real estate securities, mutual funds—ought to be required?

Mr. LEMKAU. We have that under study, Mr. Chairman. It seems to me if they are going to be selling mutual funds alone it has been requested that there be a special examination set up for them. The question is, Are they really going to stay in the mutual fund business or will they get in the regular securities business as well? The same would apply to real estate syndicates where we have been asked by outside parties to see if we could not assist them in forming examinations.

Mr. STAGGERS. Somehow I assumed you had that regulation. My next question is, Does the NASD have higher examination standards for principals and supervisors of broker-dealer firms than for salesmen? If you do not have any for salesmen, do you have them for others?

Mr. LEMKAU. We have them for salesmen entering the business.

Mr. STAGGERS. What about the supervisors and principals?

Mr. LEMKAU. We have them for principals. We are putting into effect on December 1 a special more difficult examination for principals. That is principals new to the business and officers new to the business.

Mr. STAGGERS. Do you believe the NASD's inspection program of selling practices of member firms is adequate for the protection of the investors?

Mr. LEMKAU. We have it under study at the present time, Mr. Chairman. A special committee is to report on the findings of the special study group to the board for action as soon as they can.

Mr. STAGGERS. When will that be, in the next few months or years?

Mr. LEMKAU. Our next board meeting is January 20. Whether they will be ready at that time to recommend actual changes in bylaws and/or regulations we do not know.

Mr. STAGGERS. How often does the board meet?

Mr. LEMKAU. The board meets, or the general meetings of the board are 3 times a year. We have had to have special board meetings during the present year for special reasons. Last year we had four board meetings, the fourth one being in December and required by the big backlog of cases which we had to clear away to think about other things when we met again in January of this year.

Mr. STAGGERS. How often and what types of inspection does NASD make of branch offices of members?

Mr. LEMKAU. I will call on Mr. Fulton for the figures on that.

Mr. FULTON. As of October 31, 1963, we have examined 1,144 branch offices or 24 percent of the branch offices.

Mr. STAGGERS. That is 24 percent?

Mr. FULTON. Twenty-four percent.

Mr. STAGGERS. 1,100 what?

Mr. FULTON. 1,144 branch offices. We examined 1,548 main offices or 34.1 percent. Total examinations for the year so far, 2,692.

Mr. STAGGERS. Is that a yearly examination, I might ask? How do you do this? Do you select certain groups or do you pick them at random?

Mr. FULTON. We have at present 37 examiners assigned to the district offices of the association. They are constantly making examinations of the members in the respective districts. In most districts, with the exception of the New York district, which is the largest district, on the basis of the figures we have now on examinations, we will make an examination every 3 years and we hope we will bring that down to once every 2 years. We are at present going to hire four additional men as examiners. So after February 1, after the training period, we will have 41 examiners who will be assigned to the districts.

Mr. STAGGERS. Mr. Lemkau, I think you have done a very fine job in presenting your views here. I think we have made a good record of perhaps what the committee wanted to know of the weaknesses and the strengths and some of the questions that we thought remained to be answered. I think from the light of this and the light of other testimony that we will receive from those who perhaps are opposed to different aspects of the bill that the committee will be able to make some decisions as to what should be in this bill, whether it should be amended, or deleted. Only by the help of yourself and others who have appeared could be possibly do the job that we expect to do.

We are trying to make as complete a record as we possibly can in our job to carry out the dictates of the committee in its responsibility in writing the laws for the protection of the people of the country. We want to thank you for your contributions, you and all the gentlemen who are with you, and wish you well.

Thank you again.

Mr. LEMKAU. Thank you, Mr. Chairman, and we will submit the items which we have promised.

Mr. STAGGERS. Thank you.

The committee is adjourned until further notice.

(Whereupon, at 1:20 p.m., the committee recessed subject to call of the Chair.)

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